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Business Valuation

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§18.1 I. INTRODUCTION TO BUSINESS VALUATION

The cornerstone to any business succession plan is knowing what the business is worth, because the business is often the largest and most illiquid asset. Hiring a professional business valuation expert to prepare a business valuation report lays a solid foundation for creating the client's business succession planning strategy as well as increasing the business's profitability, optimizing its value, and ensuring its marketability. Also, valuing the business often minimizes multi-generational disputes.

Valuation is not an exact science. Just as public stock prices fluctuate on any given day, the values of closely held companies tend to reflect even greater uncertainty, which suggests a wider spread of possible values. There is no universally accepted single method or answer to any valuation problem.

NOTE™ Business valuation experts must consider more than 600 factors with varying influence on the final reconciliation of value. Depending on the degree of influence, weight will be given to the factors, methods, and approaches most likely to best capture the investors' return expectations. The nexus of legal and economic theories is often considered and applied in the expert's valuation conclusion.

Determining value depends on knowing from the outset the purpose of the report, the nature of the industry, the business being valued, and the relevant economic and tax factors. Conflicting valuations usually result from widely differing interpretations of and subsequent assumptions relating to these factors or from inappropriate applications of valuation methods.

This chapter will acquaint the practitioner with the theory and practice of business valuation in order to advise clients and work with business valuation experts when creating business succession plans. This chapter also provides a general discussion of the myriad considerations and standards that a business valuation expert is expected to follow to provide a value opinion that meets the scrutiny of third parties and assists counsel and client in developing well-reasoned business succession plans. Because the topic of valuation is so comprehensive, this chapter can only provide an introduction to the subject and is not meant to be an exhaustive study.

§18.2 A. Treatises on Business Valuation

There are a host of secondary sources on business valuation. A short list of some of these sources includes the following:

- Laro & Pratt, Business Valuation and Taxes: Procedure, Law and Perspective (2005). This comprehensive resource for guidance on procedures for tax-related valuation issues is from Judge David Laro of the United States Tax Court and Shannon Pratt, business valuation expert.
- PPC's Guide to Business Valuations (2009). One of the standard reference works for valuation professionals.
- Pratt, The Lawyer's Business Valuation Handbook: Understanding Financial Statements, Appraisal Reports, and Expert Testimony (2000). This concise reference book helps judges and attorneys understand and evaluate expert reports and testimony on business valuation issues.
- Pratt, Reilly & Schweihs, Valuing a Business: The Analysis and Appraisal of Closely Held Companies (4th ed 2000). Considered a classic since its first edition almost 20 years ago, this book is considered the primary reference work for business valuation. This reference also presents a wealth of recent court cases for each valuation area, which together provide a comprehensive overview of all the legal rulings and trends in the field of business valuation.
- Pratt, Reilly & Schweihs, Valuing Small Businesses and Professional Practices (3d ed 1998). This book has been the essential reference for performing accurate small business valuations. The guide takes readers through the valuation process, featuring chapters on valuation for estate plans, employee stock ownership plans, and corporate partnership dissolutions and buyouts.
- Risius, Business Valuation: A Primer for the Legal Professional (2007). This book provides the attorney with an excellent summary (with diagrams and charts) of business valuation. It includes sections on dealing with business valuation experts and provides an overview of the various methods of valuation, with additional chapters dealing with specific valuation issues.

§18.3 B. Websites on Business Valuation

These websites provide information on business valuation:

- The Uniform Standards of Professional Appraisal Practice (USPAP) are the generally accepted standards for professional appraisal practice in North America. For discussion of these standards, see §18.6. For a copy of the USPAP, see http://commerce.appraisalfoundation.org/html/USPAP2008/index.htm.
- The International Glossary of Business Valuation Terms (AICPA International Glossary) can be found at http://fvs.aicpa.org/NR/rdonlyres/4D8EA51C–354B–4972-AA13–63918271FBCF/0/International_Glossary_of_BV_Terms.pdf.

§18.4 II. SELECTING BUSINESS VALUATION EXPERT

A competent business valuation expert should be retained as early in the planning process as possible. The right business valuation expert will state a value for the business that will be defensible in federal and state courts. Clients may be reluctant to pay for the cost of a professional business valuation report, but a formal report is invaluable when a plan is scrutinized by the Internal Revenue Service. Further, the report often lays the groundwork for assisting the business owner in enhancing the business before sale or transfer, which may not occur until years after the business is transferred to succeeding generations. Therefore, the selection of the right valuation expert is very important.

PRACTICE TIP™ Ideally, the business valuation expert should be retained 3 years in advance to afford adequate time to prepare the business and achieve the optimal transition and sales price.

There is considerable debate among practitioners about what constitutes adequate experience and skills to be a "qualified" business valuation expert. At a minimum, the business valuation expert should have the following:

- Professional designation from one or more professional organizations. For different types of designations, see §§18.8–18.11.
- At least 5 years of full-time business valuation experience.
- Experience testifying as an expert in support of his or her valuation. This ensures that the business valuation analyst's work product is defensible before a court. On requirements for admissibility of analyst's opinion in federal and state courts, see §§18.13–18.14.
- Continuing education to remain current on theory and practice. Valuation is an ever-changing profession because of the number of court decisions and development of new business valuation methods and theories.

PRACTICE TIP™ An even more preferred attribute of a potential business valuation expert would be the fact that he or she is a contributing author to publications on existing and new peer-reviewed valuation theories, which generally demonstrates a full understanding of existing theory and practice.

For a checklist of considerations in retaining an appraiser, see §18.16.

§18.5 A. Professional Standards and Designations

Business valuation experts do not have a single uniform accrediting body or set of professional standards (other than the generally accepted Uniform Standards of Professional Appraisal Practice

(USPAP); see §18.6) but instead have several independent professional organizations, each with its own standards and certifications. The business valuation standards of the different organizations are not materially different by design, but there are semantic conflicts in reporting standards. However, several common themes exist. All of the standards

- Are considered to be minimum standards or requirements, and the business valuation expert should expand his or her analysis beyond the minimum when developing a report;
- Address ethics, either directly in the body of the standards or by reference to ethical standards printed elsewhere; and
- Address the development of a valuation analysis and its presentation in a written report.

On professional standards issued by the Appraisal Foundation and the IRS, see §§18.6–18.7. Professional designations are organized by the credential offered; see §§18.8–18.11 for an introduction to the issuing organization's standards for a particular credential and resources for finding more detailed information.

1. Professional Standards

§18.6 a. Uniform Standards of Professional Appraisal Practice (USPAP)

The Appraisal Foundation is a nonprofit organization established in 1987 that promotes the advancement of professional valuation. It issues the Uniform Standards of Professional Appraisal Practice, which includes two standards of appraisal practice, Standards 9 and 10, that apply to business valuation. The Appraisal Foundation does not indicate who must comply with these standards; rather, professional organizations may require their members to adhere to USPAP. In addition, the USPAP are generally the default standards for appraisers who are not members of any professional organizations. The Appraisal Foundation and the USPAP can be found online at http://www.appraisalfoundation.org.

USPAP Standard 9 addresses the development of a credible business appraisal report; Standard 10 addresses the content of a business appraisal report. The USPAP directs professionals as follows (USPAP, Standards Rule 9–4, 2008–2009 ed):

> In developing an appraisal of an interest in a business enterprise or intangible asset, an appraiser must collect and analyze all information necessary for credible assignment results.

This standard provides support for obtaining a variety of information relating to the subject company. The business valuation expert thus will need to perform an adequate investigation and analysis that will depend greatly on the particular facts and circumstances for the purpose behind the report.

§18.7 b. IRS Business Valuation Standards

The Internal Revenue Service's Business Valuation Standards were released in July 2006. The standards apply to all IRS employees who provide valuation services and to those who provide valuation services or review valuations for the IRS. They may be found at http://www.nacva.com/PDF/IRS_Guide_02.pdf.

2. Professional Designations

§18.8 a. Certified Business Appraiser (CBA)

The Institute of Business Appraisers (IBA) offers the designation of certified business appraiser to members who meet the credential's requirements for education, training, and experience. Approximately 10 percent are designated CBA, which is granted after satisfactory completion of an examination and review of two demonstration reports.

The IBA is a voluntary organization of professionals who perform business valuations, including certified public accountants (CPAs), business brokers, and others. The IBA publishes seven business valuation standards for its members to follow, including four standards on reporting, one standard on expert testimony, one standard on professional conduct and ethics, and one standard on conducting a business appraisal assignment. More information about the IBA, including its standards, is available on the IBA website at http://www.go-iba.org.

§18.9 b. Certified Valuation Analyst (CVA) and Accredited Valuation Analyst (AVA)

The National Association of Certified Valuation Analysts (NACVA), founded in 1991, is a professional organization whose members generally practice in areas of business valuation and litigation support. The organization issues business valuation-related credentials for certified valuation analyst (CVA) and accredited valuation analyst (AVA). The only significant difference between the credentials is that only CPAs may obtain a CVA, whereas anyone may earn the AVA.

The NACVA issues professional standards required to be followed by its members performing business valuations. Paraphrased and incorporated in the NACVA Professional Standards are the eight factors of fundamental business valuation analysis listed in Rev Rul 59–60, 1959–1 Cum Bull 237 (see §18.24), which form the minimum core analysis of a subject company. These factors are repeated in the standards of most organizations. The NACVA adds a ninth factor, listed as letter "i" below. NACVA Standard 3.4 states the following:

> In developing a conclusion of value, the member must obtain and analyze information necessary to accomplish the assignment, including:
> a. The nature of the business and the history of the enterprise;
> b. The economic outlook in general and the condition and outlook of the specific industry in particular;
> c. The book value of the interest to be valued and the financial condition of the business;
> d. The earning capacity of the enterprise;
> e. The dividend paying capacity of the enterprise;
> f. Whether or not the enterprise has goodwill or other intangible value;
> g. Sales of interests and the size of the block of interest to be valued;
> h. The market price of interests of enterprises engaged in the same or a similar line of business having interests actively traded in a free and open market; and
> i. All other information deemed by the member to be relevant.

In NACVA Standard 3.9, "Financial Statement Adjustments," the NACVA instructs its members that

> historical financial statements should be analyzed and, if appropriate, adjusted to reflect the appropriate asset value, income, cash flows and/or benefit stream, as applicable, to be consistent with the valuation method(s) selected by the member.

Detailed financial data, such as general ledgers, need to be examined by the appraiser to determine appropriate adjustments. More information regarding the NACVA, including its professional standards, can be found on the NACVA website at http://www.nacva.com.

§18.10 c. Accredited Senior Appraiser (ASA) and Accredited Member (AM)

The American Society of Appraisers (ASA) is a voluntary organization of professionals who perform many kinds of appraisals, including business valuations. The ASA has developed courses and examinations for two accredited designations, Accredited Senior Appraiser (ASA) and Accredited Member (AM). Members are expected to earn the designation before performing any kind of appraisal independently.

The ASA issues Business Valuation Standards (BVS) that are similar to those of the NACVA (see §18.9) and the AICPA (see §18.11). The ASA standards also include "Statements on ASA Business Valuation Standards" (SBVS) that clarify, interpret, explain, or elaborate on the standards. These statements have the full weight of the standards.

More information about the ASA, including ASA business valuation standards, is available at http://www.bvappraisers.org.

NOTE™ The ASA's business valuation standards are to be used in conjunction with the Uniform Standards of Professional Appraisal Practice (USPAP) (see §18.6) and the ASA's Principles of Appraisal Practice and Code of Ethics, available at http://www.appraisers.org/ProfessionalStandards/CodeOfEthics.aspx. Periodic updates to these standards are posted at http://www.bvappraisers.org.

§18.11 d. Accredited Business Valuator (ABV)

The American Institute of Certified Public Accountants (AICPA) is the national professional organization for certified public accountants (CPAs). The AICPA issues the Accredited in Business Valuation (ABV) credential to qualified CPAs practicing business valuations. The credential requires a 1-day exam and represents completion of ten business valuation engagements.

The AICPA also promulgates the Statement on Standards for Valuation Services No. 1: Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset (SSVS), available at http://tax.aicpa.org/NR/rdonlyres/672E1DD4–2304–47CA-8F34–8C5AA64CB008/0/SSVS_Full_Version.pdf. The Statement establishes standards applicable to all AICPA members performing a business valuation (AICPA Standards). It essentially requires all CPAs to follow the standards, regardless of whether they are members of the AICPA, because many state boards of accountancy, such as California's, require CPAs to follow the AICPA Standards.

The AICPA Standards include a section on "Analysis of the Subject Interest" (AICPA Standards ¶¶25–30) that addresses the need for obtaining and evaluating financial, nonfinancial, and ownership information. In addition, references to specific information the CPA should consider are included throughout. Besides specifically referring to customary documents such as financial statements and tax returns, the AICPA Standards state that the CPA should consider information on compensation for owners, including benefits and personal expenses. AICPA Standard ¶29. The AICPA Standards clearly indicate that detailed financial data, as well as nonfinancial data, are required for a credible business valuation.

The AICPA Standards list examples of important nonfinancial information for the CPA to consider because assessing risk cannot be done on the basis of financial data alone. Such nonfinancial information includes the nature, history, and background of the company; its facilities; its organizational structure; its management team; classes of equity ownership interests and attendant rights; products and services; economic environment; geographical markets; industry markets; key customers and suppliers; competition; business risks; strategy and future plans; and governmental and regulatory environment. AICPA Standard ¶27. Of this list, business risks are significant because of their high influence on value.

NOTE™ "Business risk" is defined as "the degree of uncertainty of realizing expected future returns of the business resulting from factors other than financial leverage." AICPA International Glossary (see §18.3).

More information regarding the AICPA in regard to business valuation is available at http://fvs.aicpa.org.

§18.12 B. Legal Standards for Expert Witness on Business Valuation

A business valuation expert may need to testify as an expert witness in support of his or her valuation report in federal or state court. However, the business valuation expert may never make it to the stand if he or she cannot establish that the opinion held as to the value of the business meets one of the threshold tests of credibility and impartiality. The threshold tests for admissibility are different in federal court (see §18.13) and state court (see §18.14).

PRACTICE TIP™ Most business valuation experts recognize that the end user of the report may be the IRS or some other third party. However, business owners, to save money, might select a valuation report that does not satisfy the prescribed standards. Although having subsequent business transfers challenged would be sufficient admonishment, practitioners should take the time to educate the client regarding the many uses of a properly prepared report.

For full discussion of all requirements for expert witness testimony in federal and state courts, see California Expert Witness Guide (2d ed Cal CEB 1991).

For a list of all tax court cases concerning valuation of business, see http://www.fairmarketvalue.com/page.php?content=eflash.

§18.13 1. Federal Test for Admissibility

A business valuation expert must comply with the *Daubert* test (named after the United States Supreme Court case *Daubert v Merrell Dow Pharms., Inc.* (1993) 509 US 579, 125 L Ed 2d 469, 113 S Ct 2786) for his or her expert testimony to be admissible in federal court. Under *Daubert,* the expert opinion must meet a minimum "threshold" level of credibility, as follows (see also *General Elec. Co. v Joiner* (1997) 522 US 136, 139 L Ed 2d 508, 118 S Ct 512):

- The theory or technique can be tested;
- The theory or technique has been subjected to peer review and publication;
- The rate of error is acceptable; and
- The method used enjoys general acceptance in a relevant scientific community.

In *Kumho Tire Co. v Carmichael* (1999) 526 US 137, 143 L Ed 2d 238, 119 S Ct 1167, the Supreme Court made clear that the trial judge's general gatekeeping obligation to expert testimony applied to specialized knowledge such as business valuation testimony. Federal Rules of Evidence 702 incorporates the holding of *Daubert* and provides that experts with scientific, technical, or other specialized knowledge that will assist the trier of fact to understand the evidence or to determine a fact in issue may testify in the form of an opinion or otherwise if the following criteria are met:

- The testimony is based on sufficient facts or data;
- The testimony is the product of reliable principles and methods; and
- The witness has applied the principles and methods reliably to the facts of the case.

Not all *Daubert* factors would be applicable to a business valuation expert. Instead, the court typically focuses on acceptance, publication, and peer review. The ultimate *Daubert* inquiry is not whether the expert's conclusions are correct but whether his or her methodology is sound. *Mike's Train House, Inc. v Lionel, LLC* (6th Cir 2006) 472 F3d 398 (analyzing expert's methodology and rejecting testimony because expert created novel methodology for purposes of litigation, and methodology revealed lack of insight into industry standards and practices).

PRACTICE TIP™ Practitioners can use The Daubert Tracker (http://www.dauberttracker.com) to track cases interpreting and applying *Daubert* and its progeny for a fee. This website includes a searchable database of all *Daubert*-related cases and offers an e-mail update of new cases as well as other related services. Practitioners can also use a free website (http://www.daubertontheweb.com) that discusses the substance and procedure of *Daubert* and allows a search of appellate decisions by circuit or field of expertise.

The business valuation expert must demonstrate that his or her business valuation report meets the *Daubert* test. To do so, the expert must include in the report his or her qualifications, the facts and evidence supporting the results, the methodologies he or she used to come to the results, and why he or she did not apply alternatives or gave them less weight. Objectivity and independence are paramount. The following are common examples of reasons that valuations fail to meet the *Daubert* test:

- Out-of-date valuation or data;
- Limited or no management interviews;
- Faulty or baseless assumptions;
- Inadequate selection, analysis, or explanation of data;
- Inadequate support for valuation risks, multiples, or adjustments;
- Arbitrary application of discounts;
- No mention of hypothetical buyer or seller;
- Absence of discussion of asset composition or earnings and revenues history;
- Absence of discussion of dividend history;
- No comparative (or limited) data;
- Failure to use all applicable approaches and methods (or to explain absence of use).

§18.14 2. California Test for Admissibility

Permissible bases for expert opinion evidence are set forth in Evid C §801(b), which provides that an opinion may be based on matters that are

- Perceived by or personally known to the witness or made known to him or her at or before the hearing, whether or not admissible (including the witness's special knowledge, skill, experience, training, and education);
- Of a type that may reasonably be relied on by an expert in forming an opinion on the subject to which his or her testimony relates (see *Buckwalter v Airline Training Ctr.* (1982) 134 CA3d 547, 554, 184 CR 659 (expert may have to rely on circumstantial evidence if there is little or no direct evidence on which to base opinion)); and
- Not precluded by law as a basis for the expert's opinion.

NOTE™ These factors for the admissibility of expert business valuation testimony as applied to the valuation of stock in a closely held corporation are discussed in *Marriage of Hewitson* (1983) 142 CA3d 874, 885, 191 CR 392. Although this discussion concerns a family law matter, the discussion is relevant to the admissibility of business valuation testimony in other matters.

If a business valuation expert's report is challenged through litigation in California, the trial court's confirmation of the report is primarily a factual determination that must be affirmed if supported by substantial evidence. *Trahan v Trahan* (2002) 99 CA4th 62, 70, 120 CR2d 814, citing *Mart v Severson* (2002) 95 CA4th 521, 115 CR2d 717 (appraisal of closely held corporate shares for buy-out under Corp C §2000 challenged). See also *Brown v Allied Corrugated Box Co.* (1979) 91 CA3d 477, 485, 154 CR 170.

The following are the main types of information an expert may reasonably rely on:

- Personal observations, tests, examinations. See *People v Wilson* (1944) 25 C2d 341, 348, 153 P2d 720.
- Reports by other experts based on their personal observations, tests, examinations. See *People v Bordelon* (2008) 162 CA4th 1311, 1324, 77 CR3d 14.
- Reliable books, treatises, and other professional literature. See *Mann v Cracchiolo* (1985) 38 C3d 18, 37, 210 CR 762.
- The expert's own "special knowledge, skill, experience, training, and education." Evid C §801(b); *People v McDaniels* (1980) 107 CA3d 898, 905, 166 CR 12.

PRACTICE TIP™ Under Evid C §804, opposing counsel may call underlying witnesses on whose information the testifying expert relies. However, the unavailability of those underlying witnesses does not preclude the testifying expert from relying on information from them.

NOTE™ Unlike federal court, passing a *Daubert* gatekeeper test (see §18.13) is not required before admitting the testimony of a business valuation expert. In California, the *Kelly* test precludes experts from relying on new scientific techniques that have not gained general acceptance in the particular field in which the technique is offered. *People v Kelly* (1976) 17 C3d 24, 30, 130 CR 144. Although the *Kelly* test is frequently misunderstood as applying to expert testimony generally, its application is limited to testimony involving "new scientific techniques." See *People v Stoll* (1989) 49 C3d

1136, 1155, 265 CR 111. For detailed discussion of *Kelly* test, see Scientific Evidence in California Criminal Cases, chap 2 (Cal CEB 2008).

§18.15 C. IRS Penalties May Result if Expert's Report Unsupported

The 20-percent penalty for an underpayment of tax resulting from a "substantial estate or gift valuation understatement" under IRC §6662(g) (and the 40-percent penalty for a "gross valuation misstatement" under IRC §6662(h)) does not apply when reasonable cause exists for the underpayment and the taxpayer acted in good faith. IRC §6664(c)(1).

For charitable contributions, the similar penalty for a "substantial valuation overstatement" (but not a gross valuation misstatement) does not apply if the taxpayer obtains a "qualified appraisal" from a "qualified appraiser" (see IRC §170(f)(11)(E)) and the taxpayer made a good faith investigation of the value of the contributed property. IRC §6664(c)(3). A "qualified appraisal" must be conducted by a "qualified appraiser" in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the IRS. IRC §6664(c)(4)(B). See IRC §170(f)(11)(E)(i). A "qualified appraiser" is someone who has earned an appraisal designation from a recognized professional appraiser organization "or has otherwise met minimum education and experience requirements" set forth in applicable regulations and who regularly performs appraisals for compensation. IRC §6664(c)(4)(C). See IRC §170(f)(11)(E)(ii). The appraiser also must meet other requirements prescribed by the IRS.

NOTE™ An individual will not be treated as a qualified appraiser with respect to any specific appraisal unless (1) he or she shows verifiable education and experience in valuing the type of property subject to the appraisal and (2) the individual has not been prohibited from practicing before the IRS (see 31 USC §330(c)) at any time during the 3-year period ending on the date of the appraisal. See IRC §170(f)(11)(E)(iii).

At a minimum, IRC §6664(c) implies that reliance on a qualified appraisal or business valuation report will likely be considered a reasonable cause for a substantial estate or gift tax valuation understatement involving business interests. However, as noted by the court of appeals in *Estate of Thompson*, TC Memo 2004–174, vacated on other grounds (2d Cir 2007) 499 F3d 129, cert denied (2008) ___ US ___, 171 L Ed 2d 863, 128 S Ct 2932, reliance on a business valuation expert does not necessarily establish reasonable cause and good faith for purposes of the reasonable cause exception to the taxpayer penalty for the undervaluation. See IRC §6664(c).

§18.16 D. Checklist: Retaining Appraiser

__ Does appraiser have requisite professional credentials, and are they current?

__ What is appraiser's educational background?

__ How long has appraiser been practicing?

__ Has appraiser ever been disciplined or disqualified by a professional organization, a court, or the IRS?

__ Is valuation the appraiser's primary vocation?

__ Who is actually going to do the bulk of the work on a given assignment?

__ What is the appraiser's experience supporting his or her opinions at audit, appeals, and trial?

__ Has the appraiser valued the subject type of business before?

__ Does the appraiser have professional liability insurance? In what amount?

__ What is the appraiser's record-retention practice and policy?

__ Does he or she plan to interview the client and/or conduct a site visit of the subject business?

__ Has he or she dealt with the legal issues presented?

__ Has the attorney seen a sample of the appraiser's reports?

__ Does the engagement letter clearly identify

- __ the client?
- __ the entity to be appraised?
- __ the specific interest to be appraised?
- __ the purpose of the appraisal?
- __ the appropriate standard of value, including the appropriate statutory reference?
- __ the form of report to be produced and whether it will be USPAP-compliant? (See §18.6.)
- __ the timing of report delivery and the acknowledgment of specific deadlines (such as an IRS Form 706 filing date)?
- __ whether, in an estate tax matter, appraisals will be done as of both the date of death and the alternate valuation date?
- __ the proposed fee structure (fixed or hourly)?
- __ a checklist of information required to conduct the appraisal?

§18.17 III. BEGINNING THE PROCESS

When engaging a business valuation expert, the practitioner should obtain the information that a business valuation expert will require to prepare the report. See §18.19. The more comprehensive the data gathering, the better the engagement.

§18.18 A. Facts Needed for Valuation

The practitioner should provide as much of the following information as he or she can to the business valuation expert:

- **When is report completion needed?** A business valuation report may require significant investigation and numerous pieces of information supplied by the client. If a client fails to provide information, it could take even more time to complete the report. It is important to build appropriate expectations about the process to expedite the report.

- **What is the date of value?** A valuation expert is typically not allowed to include facts that occurred after the valuation date as part of his or her report. Thus, it is important to know what was known and foreseen as of the date(s) of value.
- **What is the purpose for the valuation, *i.e.*, dispute resolution, litigation, estate, buy-sell, or other?** In most circumstances, the engagement will be influenced by the purpose of the valuation. Once the purpose is understood, it will identify the correct methodologies and legal standards for valuation. For example, in some situations, a dissenting shareholder dispute often relies on a "fair value" valuation approach. (For definition of "fair value," see §18.33.) The valuation expert would not apply discounts for lack of control or illiquidity. Conversely, for tax purposes, the fair market value standard is likely applied and would commonly influence the valuation.
- **What is the standard of value?** This is the type of value being used in a specific transaction. On different types of value, see §§18.21–18.38. Value may be different depending on the circumstances of the buyer or seller. For example, the intrinsic value of a business is different than market price or book value. The intrinsic value includes variables such as brand name, trademarks, and copyrights, which are often difficult to calculate and sometimes not accurately reflected in the market price. One way to look at it is that the market price is the price that investors are willing to pay for the company, and intrinsic value is the value that the company is worth to its owners, which may be dependent on other factors that would not motivate an individual investor. However, most investors are motivated to buy or sell on the basis of identifiable factors such as levels of governance, operational control, and return expectations, which will normally be reflected in a prorata fair value or fair market value.

  NOTE™ Depending on the engagement's purpose, one or more standards of value may apply.
- **Is the business a corporation, partnership, limited liability company (LLC), or sole proprietorship?** The type of business will influence the valuation as well as the type of documents requested.
- **Are there any business provisions that would influence the value?** The provisions in a buy-sell agreement or an employee stock option plan (ESOP) may influence value. For example, a buy-sell agreement might provide for put and call options that influence the repurchase obligation. The key point is that sufficient detail is needed to have a clear understanding of the scope of the engagement. On buy-sell agreements, see chap 6; on ESOPs, see chap 13.
- **Gross sales and income?** Understanding the difference between a business's gross sales and income may be important depending on the business being valued. For example, a common error in determining the level of sales for an insurance agency results from confusion about aggregate billings versus commission income. Greater sales often result in higher degrees of complexity, but not always. For example, a $15 million plastics extrusion company making aquariums may be no less complex than one with $150 million in sales. This is likely industry-specific.
- **Number of years in business?** Characteristics of early-stage versus mature companies, even in the same industry, are often quite different. A cabinet maker in business for 3 years with $3 million in annual revenues versus one having operated for 25 years with the same level of sales may be approached differently on the basis of typical sales volume for the duration in business. The degree of requested documentation may differ as well.

- **Where is business located and number of locations?** A $300 million scrap-metal yard outside of Detroit with sub-locations in the Southeast may require more on-site due diligence than a local chain of nail salons in Los Angeles.
- **Does the business own real estate or considerable tangible or intangible assets?** It is important to know what underlying assets the business owns. Moreover, it is important to completely understand how the asset is owned and under what terms it is owned. For example, rarely would the real estate's book value (for definition of "book value," see §18.27) be considered in estimating its value; rather, its value would need to be adjusted to reflect its market value.
- **Does the business serve a niche market?** This inquiry assists in identifying the level of complexity of the business. For example, a doll wig distributor may rely on catalog sales and the Internet for a national or international market, whereas a trendy all-day spa may rely on affluent locals within a 2-hour limousine ride.
- **Other issues impacting the value?** Occasionally, a client will want to know the value of an enterprise if a key employee had insurance coverage making the enterprise or other shareholders the beneficiary versus its value if no such policy were in place. The former tends to mitigate loss. A contingent liability, such as a pending lawsuit with a significant supplier, may exist that could radically change the fortunes of the existing shareholders; such a liability might require examining a considerable number of documents that might not need examination absent such a dispute. In the case of a joint retention, divergent versions of the same event among disputing shareholders may create disparate outcomes that will need to be reconciled.

§18.19 B. Checklist: Documents Needed for Valuation

I. Permanent Records, Contracts, and Agreements

__ Life insurance policies for all key employees or officers

__ Lease agreements for all occupied facilities

__ Articles of incorporation, operating agreement, or partnership agreement with all amendments

__ Front and back of stock certificates

__ Bylaws

__ Shareholder agreements

__ Employee agreements

__ Labor contracts

__ All buy-sell agreements in effect on _ _[*insert date of valuation*]_ _

__ Covenants not to compete

__ Loan agreements for loans outstanding on _ _[*insert date of valuation*]_ _

__ Any other legal agreements in effect

__ Escrows, deeds, notes, or other documents associated with any real property purchases

__ Operating agreements with any customers or vendors accounting for greater than 10 percent of revenues or purchases

__ Reports of any consultants or appraisals performed within the past 5 years

__ Minutes of all shareholder, member, or partnership meetings for the past 5 years

__ List of any transactions in company stock, membership interests, or partnership interests since inception

__ Previous offers to purchase company assets, stock, or other ownership interests.

II. Historical Financial Information

__ Records from last 5 years, including current year

- __ Federal and state income tax returns, with all schedules, forms, and attachments
- __ Year-end financial statements (preferably prepared by CPA)
- __ List of affiliated companies, partnerships, or proprietorships and their financial statements for the last 5 years
- __ List of major suppliers, including amount of purchases in each of last 5 years

__ Records from preceding year and current year

- __ Interim financial statements (monthly or quarterly)
- __ General ledgers
- __ Cash disbursement journals and check registers
- __ Cash receipts journals and deposit statements
- __ General journals
- __ Federal and state payroll tax returns for all quarters
- __ Other regular management reports

__ Records for most current fiscal year-end

- __ Year-end detail and aging of accounts receivable
- __ Year-end detail and aging of accounts payable
- __ Year-end listing of all fixed assets at detail level
- __ Year-end listing of inventory at detail level

__ Prospective financial information

- __ All financial budgets and projections
- __ Expected capital expenditures for next 5 years
- __ Sales forecasts by product line and division and description of product development process (*e.g.,* R&D)

III. Other Information

__ Schedule listing top five customers (clients) in terms of revenues by year for each of past 5 years, and revenues earned from each of these customers by year

__ A list of order backlog and monthly backlogs for last 3 years

__ Sales and gross profit by product or service line for each of past 5 years

__ Estimate of sales breakdown by geographical region or state for each of past 5 years

__ Brief written description of company and its products and services

__ List of major competitors and their locations

__ Brief background of the owner and all key employees, including compensation (for last 5 years), age, education, years with company, years in industry, job title, and general responsibilities

__ Current list of shareholders, members, and partners; their ownership interests; and type of ownership interest (*e.g.,* Class A common stock)

__ All printed brochures, flyers, and similar documents describing company and its products and services

__ Newspaper or magazine articles regarding company products, services, or key employees

__ Samples of trade publications regularly received by company

__ Names of trade associations in which company is member

__ Organization chart

__ Documentation regarding pending litigation and assessment of contingent liabilities

__ Summary of pension and profit-sharing plans

__ Documentation regarding receipt of, granting of, or exercise of stock options

__ List of any assets or liabilities not listed on either company financial statements or tax returns as of date of value

__ List of financial interests in subsidiaries and other companies

__ Brief history, including how long in business and details of any changes in ownership and any bona fide offers recently received

__ Brief description of business, including how it compares to local competition, and any attributes that make business unique

__ Any filings or correspondence with regulatory agencies

Comment: This is a checklist of initial documents that may be needed depending on whether the business or ownership interest subject to the engagement is an operating business or an asset-holding company and the purpose of the engagement. These documents should provide sufficient background for the business valuation analyst to begin the process of research and analysis. Subsequent questions that will require more information will likely be raised on review. For a checklist of drafting considerations and items that should be included in the appraisal report, see §18.39.

§18.20 C. Retention Agreement

The retention agreement between a business valuation expert and the client should outline all services so that it is clear which services are to be performed. The agreement should specify the following:

- The purpose of the agreement;
- The scope of the engagement (*e.g.,* written or oral report);
- The date of value;
- The purpose for the valuation;
- The standard of value (*e.g.,* fair market value; see §§18.22–18.31); and
- How fees are to be charged (*e.g.,* hourly or flat fee with a "not to exceed" number).

EXAMPLE™

Purpose and Objective of Engagement. **The objective of the analysis is to provide an independent opinion of the Fair Market Value of the 33.33-percent interest held by the decedent in ABC Corporation on a going-concern, noncontrolling, cash equivalent basis as of May 25, 2010. The purpose of this valuation is to assist in the considerations involving relevant parties incident to estate tax purposes of the decedent's ownership interest held. The analyses were conducted for this purpose only.**

§18.21 IV. DEFINING VALUE OF BUSINESS

Before a business valuation expert can begin the valuation process, he or she must know how the value of the business will be defined. Numerous ways exist to value a business; the appropriate method will depend on the purpose of the valuation and the facts and circumstances of the business itself. For example, will the valuation be prepared for the eventual sale of a business, for an ongoing business concern, or for a business that expects to be sold immediately?

The discussion in §§18.22–18.31 concentrates on the fair market value of a business because this type of value is most often used when valuing a business for business succession planning purposes. For a short summary of the various other types of values that can be used when valuing a business, see §§18.32–18.38.

§18.22 A. Definition of "Fair Market Value"

The definition of "fair market value" is particularly important when preparing a business succession plan. Numerous estate and gift tax-related transactions will take place, and the planner must know the business's fair market value. The Treasury Regulations provide two definitions, one for estate tax purposes and one for gift tax purposes, but they are essentially the same.

- For *estate tax* purposes, fair market value is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. Treas Reg §20.2031–1(b); Rev Rul 59–60 §2.02, 1959–1 Cum Bull 237.
- For *gift tax* purposes, fair market value is defined as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to

buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Treas Reg §25.2512–1; Rev Rul 59–60 §2.02, 1959–1 Cum Bull 237.

To understand fair market value, the language of the laws and regulations is examined more carefully below:

- **The price at which the property would change hands.** Fair market value assumes a (hypothetical) transaction, even if no actual one will occur. The standard is therefore a transactional standard.
- **Between a willing buyer and a willing seller.** If there are no buyers or sellers, the valuation analyst may need to consider the universe of potential (hypothetical) willing buyers and sellers.
- **When the former is not under any compulsion to buy and the latter is not under any compulsion to sell.** This is not about forced transactions. In the real world, buyers and sellers always have reasons that they engage in transactions. Financial distress or other reasons that might compel a hypothetical seller or buyer to engage in a transaction may not be considered.
- **Both parties having reasonable knowledge of relevant facts.** The hypothetical willing buyers and sellers are informed about the subject of the valuation as well as about alternative investments, as the guidance makes clear. Court decisions frequently add that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade. In other words, hypothetical buyers and sellers must have the financial capacity and knowledge to engage in a transaction.
- **And both parties being well informed about the property and concerning the market for such property.** Hypothetical willing buyers and sellers are required to be informed, not only about the specific subject of the valuation but also about the market in which the property trades. If no market exists, then the hypothetical sellers and buyers must be informed about the markets for *alternative* investments that would shed light on the value of the subject business.

In many ways, defining the fair market value of a business is at best an inexact science. No single software program or simple formula will value all types of business. As the IRS acknowledged in its seminal ruling in Rev Rul 59–60, §§3.01 and 3.03, 1959–1 Cum Bull 237, when determining fair market value in general,

> .01 A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.
>
> ….
>
> .03 Valuation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal. As a generalization, the prices of stocks which are traded in volume in a free and active market by informed persons best reflect the consensus of the investing public as to what the future holds for the corporations and industries represented. When a stock is closely held, is traded infrequently, or is traded in an erratic market, some other measure of value must be used. In many instances, the next best measure may be found in the prices at which the stocks of companies engaged in the same or a similar line of business are selling in a free and open market.

§18.23 1. IRS Factors

The IRS has set forth the factors it uses to value a business for estate tax purposes in Rev Rul 59–60, 1959–1 Cum Bull 237, and Treas Reg §20.2031–3. For a list of these factors, see §18.24. Revenue Ruling 59–60 recognizes that both the willing buyer and the willing seller are hypothetical constructs and the actual identity of the donor and donee or decedent and beneficiary are irrelevant.

Two Ninth Circuit cases are helpful in understanding both the concept of the hypothetical willing buyer and willing seller and the burden of proof. In *Alice Friedlander Kaufman,* TC Memo 1999–119, rev'd sub nom *Morrissey v Commissioner* (9th Cir 2001) 243 F3d 1145, the Tax Court refused to take into consideration sales of stock by family members 2 months after the valuation date. In addition, the Tax Court speculated on the ability of a 20-percent shareholder to influence corporate policy and the possibility that an existing shareholder might acquire the 20-percent interest in an attempt to gain control. In reversing the Tax Court, the Ninth Circuit pointed out that the asset being valued is the asset being transferred, not "the potential of the property to be realized at a later date." See also the decision of the Ninth Circuit reversing the Tax Court in *Estate of Simplot v Commissioner* (9th Cir 2001) 249 F3d 1191, 1195, in which the Tax Court assigned a premium to a minority block of voting stock. In surprisingly harsh language, the Ninth Circuit stated:

> 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 its 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", i.e., all of these imagined facts, are what the Tax Court based its 3% premium upon. In violation of the law the Tax Court constructed particular possible purchasers.… Speculation is easy but not a proper way to value the transfer at the time of the decedent's death.

NOTE™ For additional factors in valuing business, see Treas Reg §20.2031–3.

§18.24 2. Revenue Ruling 59–60 Factors

The IRS has set forth eight factors to consider when valuing stock in closely held corporations for estate and gift tax purposes (Rev Rul 59–60, 1959–1 Cum Bull 237):

(1) The nature of the business and the history of the enterprise from its inception (see §18.25);

(2) The economic conditions in general, and the condition and prospects of the specific industry in particular (see §18.26);

(3) The book value of the stock and financial condition of the business (see §18.27);

(4) The company's earning capacity (see §18.28);

(5) The company's dividend-paying capacity (see §18.28);

(6) Whether the enterprise has goodwill or other intangible value (see §18.29);

(7) Sales of the stock and size of the block of stock to be valued (see §18.30); and

(8) Comparable market prices of traded stock of corporations engaged in the same or similar line of business (see §18.31).

NOTE™ Under Rev Rul 68–609, 1968–2 Cum Bull 327, the eight factors now apply to any type of business interest.

For discussion of application of these factors under California law, see *Marriage of Hewitson* (1983) 142 CA3d 874, 191 CR 392. In *Hewitson,* the court listed and discussed a variety of approaches that may

be used to decide the investment value and the market value of closely held shares. 142 CA3d at 881. While *Hewitson* is a family law case, the discussion of the valuation factors is relevant for other business valuation purposes.

§18.25 a. Nature and History of Business

The business valuation expert's report should include a satisfactory description of the subject business interest, the business's assets and equities, and how the business operates. This description should include an analysis of past transfers, examination of provisions in the business's bylaws, contractual agreements, articles of incorporation, and other legal documents. The analyst should review tax returns and finance documents over the last 3 to 5 years, business or strategic plans, marketing material, and current and future budgets and forecasts. Moreover, the business analyst should evaluate the business management's skill, education, depth, and health. See Rev Rul 59–60 §4.02(a), 1959–1 Cum Bull 237.

§18.26 b. Economic and Industry Outlook

The business valuation expert's report should review the present and future outlook for the subject business. Businesses do not operate in a vacuum. For example, in the early 2009 economy, capital for purchasing equity or debt to finance growth was difficult to obtain even by banks and publicly traded companies. This difficulty decreased the value of many companies. Tighter capital tends to reduce growth and curtail profitability. Thus, it is important that the report include trusted and respected information on the economic outlook for the subject business's particular industry. See Rev Rul 59–60 §4.02(b), 1959–1 Cum Bull 237.

§18.27 c. Book Value of Stock; Business's Financial Condition

An asset's book value is the historical cost of the asset on the company's books, less accumulated depreciation, depletion, and amortization. Liabilities are usually shown at face value. Sometimes an intangible asset appears on the balance sheet if the actual cost of development was recorded or if the asset was purchased. The book value of a business is the difference between the book value of the total assets and the total liabilities as they appear on the books. "Book value" is synonymous with "net worth" and "shareholders' equity."

Although business valuation experts usually consider the book value approach, that approach is often less relevant to going-concern valuations. "Book value" is not actually a form of value but an accounting term. Generally, it is not a fair representation of value unless most of the underlying assets are liquid in nature and are on the books at close to their fair market values. Types of business enterprises that lend themselves to the use of book value are those that match depreciation with decline in value over time or those that are constantly adding to their fixed assets so that depreciated book value is not widely divergent from market value.

If the book value is not considered to accurately represent the current fair market value of the underlying assets and liabilities, that amount must be adjusted for known variances between book value and market value and any other contingencies. However, for most companies, the going-concern value may differ widely from asset value because the latter makes no allowances for goodwill. Asset value ordinarily becomes a significant factor in the appraisal only when the entity's liquidating value is close to or exceeds its earning power value. This "adjusted book value" method is most often used for

nonoperating companies whose value lies primarily in their assets, such as real estate holding companies, natural resource companies, and investment companies.

To assess the business's financial condition, the business valuation expert must analyze the operation of the business, review different segments of the business concerning its profitability, and evaluate the future prospects of the business for its growth or contraction. See Rev Rul 59–60 §4.02(c), 1959–1 Cum Bull 237.

§18.28 d. Earning and Dividend-Paying Capacity

This is typically a less important standard for valuing a business. Although historical data on the amount and frequency of dividend payments is important, the more important consideration is the ability to pay dividends and not whether the dividends were actually paid. See Rev Rul 59–60 §4.02(d)–(e), 1959–1 Cum Bull 237.

§18.29 e. Intangible Assets and Goodwill

Goodwill is one of a number of intangible assets that does not have a standard definition. "Goodwill" generally consists of the benefits that accrue to a business as a result of its location; reputation for dependability, skill, or quality; and any other factors resulting in probable retention of old or acquisition of new patronage. Some authorities equate goodwill solely with the excess of net earnings over a fair return on the net tangible assets or with the excess of net earnings over earnings normally encountered in the particular industry. However, it is not necessary for a firm to have "excess earnings" to have a goodwill value.

In accounting usage, goodwill usually reflects the amount by which the purchase price of a business exceeds the fair market value of the business's identifiable assets. Goodwill is only one of the possible intangible assets of a business. Others include contracts, customer lists, patents, copyrights, trademarks, franchises, computer software, and certain proprietary operating techniques. See Rev Rul 59–60 §4.02(f), 1959–1 Cum Bull 237, as modified by Rev Rul 65–193, 1965–2 Cum Bull 370.

NOTE™ A company can have a significant value with only its value of intangible assets. For example, if every building and piece of equipment of Coca-Cola were destroyed and every employee called in sick, Coke's brand trademark and the patent for Coke's recipe would still be worth billions of dollars.

§18.30 f. Sales of Stock and Block Size

Prior stock transactional history, if at arm's length and at the appropriate standard of value, often provides a good benchmark of a non-duress arm's-length transaction. The premium or the impairment (discount) for control, voting rights or governance, and repurchase liability (liquidity) influence adjustments to value. See Rev Rul 59–60 §4.02(g), 1959–1 Cum Bull 237.

EXAMPLE™ The value of a 2-percent interest in a business may be considerably different if there are only three shareholders and the other two each own 49 percent of the business and the business's documents require a majority vote for all decisions. This 2-percent interest may have significantly more value than if there were 50 2-percent shareholders.

§18.31 g. Market Price of Stock in Same or Similar Companies in Similar Industry

Because the availability of data is relatively thin for closely held businesses, the transactional data must be carefully evaluated to determine whether it provides a reasonable (not exact) estimate of the business being valued. When unusual aspects of the transaction exist (such as whether the transaction was all cash or (un)favorable financing or whether the time frame, duration of listing, or cyclical nature of the industry makes multiples of earnings or revenues more challenging to isolate), it is imperative that these issues be described and addressed. See Rev Rul 59–60 §4.02(h), 1959–1 Cum Bull 237.

§18.32 B. Standards of Value Other Than Fair Market Value

A business may be valued under standards other than fair market value. Value may be determined because the purpose of the valuation sets the appropriate value, or the parties may define value that is based on agreement. Some of these other types of values are defined in §§18.33–18.38.

§18.33 1. Acquisition Value

"Acquisition value" refers to the actual price paid for a transaction. It sometimes refers to the value of a business to a particular individual. Acquisition value reflects the unique synergies achieved by one particular purchaser. Often the purchaser is willing to pay a premium above the price paid for all outstanding shares. For example, this may happen when the purchaser may obtain an immediate market share. Occasionally, acquisition value is seen as a subset of investment value (see §18.38).

§18.34 2. Fair Value

Fair value is most often applied in the accounting field with the intention of identifying something akin to fair market value. Under generally accepted accounting principles (GAAP), on the balance sheet it is the amount for which an asset or liability could be bought, sold, incurred, or settled between unrelated willing parties, other than in liquidation.

§18.35 3. Liquidation Value

"Liquidation value" is defined as the net amount that would be realized if the business were terminated and the assets sold piecemeal. Liquidation can be either orderly or forced. Orderly liquidation value refers to the value at which the asset or assets are sold over a reasonable period of time to maximize proceeds; forced liquidation value refers to the value at which the asset or assets are sold as quickly as possible, such as at an auction. See AICPA International Glossary (see §18.3).

§18.36 4. Going-Concern Value

"Going-concern value" is defined as (AICPA International Glossary; see §18.3):

> the value of a business enterprise that is expected to continue to operate into the future. The intangible elements of ["going-concern value"] result from factors such as having a trained work force, an operational plant, and the necessary licenses, systems, and procedures in place.

§18.37 5. Intrinsic Value

"Intrinsic value" refers to (AICPA International Glossary; see §18.3):

> the value that an investor considers, on the basis of an evaluation or available facts, to be the "true" or "real" value that will become the market value when other investors reach the same conclusion. When the term applies to options, it is the difference between the exercise price and strike price of an option and the market value of the underlying security.

A simple example would be an owner unwilling to sell the family farm for $2 million, its intrinsic value, despite its having a market value of $500,000.

§18.38 6. Investment Value

"Investment value" refers to "the value to a particular investor based on individual investment requirements and expectations." AICPA International Glossary (see §18.3). This definition deals with specific versus hypothetical buyers and sellers ("investors").

§18.39 C. Checklist: Appraisal Report

__ Is addressed to the right party

__ Contains clear statement of assignment

__ Identifies intended user and use correctly

__ Identifies entity and specific interest appraised

__ Specifies valuation dates

__ Identifies appropriate standard of value

__ Identifies any assumptions or limiting conditions

__ Contains USPAP compliance statement (see §18.6)

__ Is opinion of appraiser signing report, not someone else

__ Was not drafted by attorney or other adviser

__ Includes discussion of legal assumptions

__ Contains all elements needed for its purpose

- __ Substantiation of charitable deductions
- __ Adequate disclosure
- __ Other _ _[*describe*]_ _

__ Includes description of business and all relevant facts

- __ History
- __ Type of entity
- __ Nature of business

- __ Capitalization and ownership
- __ Management and directors
- __ Products and services
- __ Customers and markets served
- __ Facilities
- __ Competition

__ Includes historical financial analysis

- __ Income statement history
- __ Balance sheet history
- __ Ratio analysis
- __ Comparison to industry averages

__ Describes adjustments to reported earnings (as needed and appropriate)

__ Includes relevant economic and industry analysis

__ Contains overview of appraisal process employed

__ Describes methods considered but not used and why

__ Describes methods used and why

__ Applies reasonable valuation methodology

__ Includes detailed exhibits

__ Includes explicit presentation of all calculations leading to stated opinions

__ Presents basis for all underlying assumptions and valuation variables

__ Describes application of valuation discounts

- __ Methodology
- __ Empirical evidence
- __ Nexus to specific fact pattern

__ Includes sources of information used

__ Cites studies or other data

__ Includes summary of appraiser qualifications

__ Satisfies general requirements that will not compromise the authority of an otherwise sound opinion

- __ Has unbiased tone
- __ Discloses and deals with “bad facts” as well as “good facts”
- __ Is free of grammatical, mathematical, and typographical errors
- __ Is clear and understandable

V. VALUATION APPROACHES, METHODS, AND TECHNIQUES

§18.40 A. Defining Valuation Methods

A valuation method is the process used to ascertain the value of a business. Value is rarely a single number. The valuation of a business is full of many individuals' judgments and estimates. For example, informed investors may have different opinions about the amount of benefits a business offers, resulting in differences between asking and offering prices (as commonly seen in public stock transactions). A rational buyer will invest only if the present value of the expected benefits of ownership is at least equal to the purchase price. Likewise, a rational seller will not sell if the present value of those expected benefits is more than the selling price. Generally, a sale occurs at an amount that approximates the benefits of ownership.

Value will depend not only on the estimate of the value of the benefits of ownership but also on other judgments. For example, investors may require different rates of return that are based on their opinions of the risks of ownership.

The business valuation analyst's task is to determine a "most likely" conclusion on which a hypothetical buyer and seller will agree. This is achieved by considering and performing various valuation approaches and methods.

NOTE™ When using a valuation method as part of an expert report, determination of the appropriate valuation method is an issue of law for the court and one that a court of appeals reviews de novo. *Estate of Jelke v Commissioner* (11th Cir 2007) 507 F3d 1317, cert denied (2008) ___ US ___, 172 L Ed 2d 43, 129 S Ct 168.

§18.41 B. Overview of Different Valuation Approaches

The following approaches are most often used by appraisers to value businesses:

- **Cost or asset approach:** This approach essentially consists of adding up the values determined for each of the business assets, including tangible and identified intangible assets. Assets are viewed at their current market value as well as at cost, book, or replacement value. See §§18.42–18.49.
- **Market approach:** This approach requires data from the market to determine the value of a privately owned company. The appraiser investigates and analyzes transactions involving similar business enterprises or the interests and shares of similar enterprises. Relevant transactions may involve acquisitions of similar closely held companies and transactions of publicly traded stocks that are examined for price-earnings, price-cash flow, price-revenue, and price-book value multiples that can be applied to the business being valued. See §§18.51–18.54.
- **Income approach:** The real value of any business enterprise, when approached on a return-on-investment basis, is its earning power. The income approach begins with an estimate of the company's income-producing capability. If historical earnings are indicative of the company's current earning power, then capitalization of historical earnings may be used. A price-earnings multiple applied to current earnings may be used, as well as discounted future earnings or discounted future cash flow, if forecast earnings are expected to be nonlinear or considerably different from past performance. Capitalization rates, discount rates, and price-earnings multiples are derived from the analysis of risks associated with alternative investments. See §§18.55–18.62.

CAUTION™ Several techniques are available in developing these risk rates. Note that this is an area where quality of analysis is particularly germane to defending the business valuation expert's value conclusion.

Each approach has unique attributes that contribute to the overall analysis of value; however, their use is not necessarily mutually exclusive. Although the specifics of valuing a business are beyond the scope of this chapter, it is helpful for the attorney to understand the foundation of business valuation theory so that he or she can better understand how to assist the business valuation expert.

§18.42 1. Cost or Asset Approach

The cost or asset approach to valuation (also called the cost- or asset-based approach) uses the concept of replacement cost as an indicator of value. This approach requires the identification of all assets, the adjustment of the assets to their respective market value, and the deduction of all liabilities. Two methods under this approach are the excess earnings method (see §§18.43–18.46) and the adjusted net assets method (see §18.47).

The premise of the asset approach is that a prudent investor-buyer would pay no more for an asset than the amount for which the asset could be replaced. Unadjusted book value (*i.e.*, total assets minus total liabilities) reflects a historical cost accounting that seldom has a relationship to market value. For valuation purposes, assets and liabilities may be adjusted to reflect their approximate current market value-in-use.

The asset approach may be an inadequate measure of value for some operating businesses because it may fail to consider the ongoing profit potential of an income-producing concern. However, the approach will often set a minimum value.

EXAMPLE™ If a manufacturer has well-serviced equipment that is fully depreciated ($0 book value) but generates millions of dollars in finished goods annually, its value-in-use is considerably higher than its book value.

§18.43 a. Excess Earnings Method

The excess earnings method is sometimes viewed as an income-based approach or a "hybrid" approach because it involves an analysis of earnings as well as return on individual tangible assets. It seeks to value goodwill by capitalizing earnings in excess of a fair return on the tangible and specific intangible assets less liabilities. The resulting goodwill is added to the appraised value of the net tangible assets. This method causes a significant adjustment reflecting the "replacement value" of an owner's services. This adjustment is often addressed by courts in discussions of this method.

NOTE™ Because the excess earnings method was introduced by the IRS and presented in the form of a formula, it is sometimes referred to as the "IRS method" or the "formula approach." It may also be referred to as the "Treasury Method."

WARNING™ The IRS has criticized this method of business valuation. See §18.45. It is discussed in this book so practitioners will understand it if a business valuation expert proposes its use for a client.

§18.44 (1) Background

The excess earnings method was introduced by the Treasury Department in 1920 through an Appeals and Review Memorandum (ARM 34, 2 Cum Bull 31) as a technique for appraising the intangible value lost by the brewing and distilling industries during the Prohibition era. This memorandum was superseded by Rev Rul 68–609, 1968–2 Cum Bull 327. See Trugman, A CPA's Guide to Valuing a Closely Held Business: Evolution of Business Valuation Services (2001), available on the AICPA website at http://fvs.aicpa.org/Resources/Business+Valuation.

§18.45 (2) IRS Criticism

Counsel should be aware of the criticism that the excess earnings method has drawn from the IRS since its introduction in 1920. See, *e.g.*, Rev Rul 65–192, 1965–2 Cum Bull 259, superseded by Rev Rul 68–609, 1968–2 Cum Bull 327. Both of these rulings, issued by the agency responsible for introducing the method, cautioned that this approach should be used "only if there is no better basis therefor available." Rev Rul 68–609, 1968–2 Cum Bull 327.

Compared to other income-based and market-based approaches, the excess earnings method is not the best approach available in many situations. This is particularly evident in light of the subjectivity embedded in determining the variable of the replacement value of the owner's services. Thus, although the approach offers some uniqueness and conceptual appeal in comparison to other approaches, it should be used only when the situation calls for it, such as when the owner's services are of the type that can be replaced (*e.g.*, a dental practice in a location where many licensed dentists are available and willing to buy the practice).

§18.46 (3) Procedure

There are many variants to the precise application of the excess earnings method. The basic procedure behind the model is as follows:

(1) Create a fair market value balance sheet;

(2) Compute a reasonable return on the net tangible and intangible assets identified on the fair market value balance sheet;

(3) Determine estimated, recurring earnings after owners' compensation;

(4) Deduct the reasonable return determined in step 2 from the estimated recurring earnings determined in step 3, which equals excess earnings; and

(5) Determine the value of the intangible assets not specifically set forth on the fair market value balance sheet by capitalizing the excess earnings.

Although the "formula" appears relatively straightforward and theoretically appealing, the method is often difficult to apply in practice. Debates have occurred over many of the variables used in the approach. The following are some of the many questions that often arise in the application of the excess earnings method:

- Should specific intangibles be included or excluded from the fair market value balance sheet?
- Should the rate of return on net assets be determined from industry sources, from an analysis of overall rates of return prevailing in the market, or by reference to the published IRS rates?
- Should the rate of return on net assets be affected by the capital structure of the subject company?

- Should an overall rate of return on net assets be determined and applied to the net assets as a whole, or should individual rates of return applicable to each asset and liability be determined and applied to the categories individually?
- Should the method be applied to assets only (*i.e.,* debt-free basis) or net assets (*i.e.,* equity model)?
- Should excess earnings be computed for each year in a 5-year analysis, or should they be based on only the current fair market value balance sheet?
- How are projected variations in the growth of the earnings stream accounted for?
- What earnings stream should be used: Net income? Net cash flow?
- What is the best way to determine a capitalization rate for the indicated excess earnings?
- What if projected earnings are not constant?

Although some will profess to know the "correct" answers to these questions and suggest "standardized" approaches that will result in the "correct" employment of the excess earnings method, they could not be farther from the truth. Any valuation method must be understood thoroughly and modified appropriately to meet the facts and circumstances of the situation. The method cannot be "standardized" to fit all cases. The appraiser should not modify the method to fit his or her client's interest. Rather, he or she should analyze the quality and availability of data in the situation and the purpose and function of the appraisal and then apply the method in the most suitable manner.

§18.47 b. Adjusted Net Assets Method

The adjusted net assets method of valuation involves the conversion of the company's balance sheet to a fair market value balance sheet, with the resulting net equity indicating the value of the entity. When applying this approach, all or some of the individual assets may be formally appraised. The expert must also employ some method to determine the value of the intangible assets. That is, the adjusted net assets method will likely be meaningless as a valuation approach if the potential existence of intangible value is completely ignored.

NOTE™ This approach is identical to the excess earnings method, absent the specific calculation of capitalized excess earnings (*i.e.,* the goodwill calculation). Under the method discussed here, the expert estimates the values of the intangible assets through other means. See §18.43.

The adjusted net asset method is most appropriate for valuing controlling interests in companies that are highly capital-intensive in nature, such as real estate holding companies and investment companies. It is generally less useful for operating entities such as those in retail, wholesale, service, manufacturing, and similar industries. This method is rarely valid in the appraisal of a minority interest.

The adjusted net asset method has advantages. In many respects, it is the easiest to understand and explain to individuals without valuation backgrounds. Furthermore, the underlying value of the assets, particularly on a liquidation basis, provides strong evidence regarding the "floor" value of an entity. Additionally, in some cases it is necessary to estimate the tangible and intangible value of a company (*e.g.,* in mergers and acquisitions or income tax situations); thus, the application of asset valuation is required. Finally, in certain appraisal situations, there may be intangible value despite the nonexistence of excess earnings. In these cases, a "cost-to-create" approach may be appropriate for determining the value of other intangible assets.

§18.48 c. Disadvantages

The asset-based approach also has significant disadvantages. The value of a collection of assets, organized as a going concern, is seldom best determined through an asset approach. This is particularly true for a minority owner, who may not have the power to force liquidation and realize the value of the underlying assets. Further, the cost of obtaining reliable appraisals of tangible assets may be prohibitive. Additionally, the appraisal of specific intangibles is often difficult and subjective, eliminating the approach's simplicity. Even when intangibles are viewed without specificity, as in the excess earnings method (assuming specific intangible assets are not valued and a return on these assets is not provided), a large degree of subjectivity results from the numerous variables that must be estimated to compute goodwill value. Failing to consider intangible value, which is sometimes done by inexperienced appraisers, may yield a result that is unreliable.

§18.49 d. Common Errors

Counsel should be aware of some common errors in the application of an asset-based approach:

- Failure to consider intangible value;
- Reliance on book value;
- Reliance on a cost or asset method in the valuation of a minority interest;
- Failure to consider other incidental costs in a liquidation approach; and
- Failure to use the appropriate value definition in the appraisal of specific assets (*e.g.*, "in-place value" versus "orderly liquidation value").

§18.50 2. Market Approach

The "market approach" (or "market-based approach" or "sales comparison approach") allows for the determination of the value of (AICPA International Glossary; see §18.3)

> a business, business ownership interest, security, or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities, or intangible assets that have been sold.

The key to the successful use of this approach is to be clear as to the sources of data, population groups, and criteria employed.

§18.51 a. Procedure

The market approach has several underlying methods:

- **Guideline public company method** is "a method within the market approach whereby market multiples are derived from market prices of stocks of companies that are engaged in the same or similar lines of business, and that are actively traded on a free and open market." AICPA International Glossary (see §18.3). Only in rare situations would the guideline public company method be applicable to small businesses or professional practices, because of the extreme diversity of business sizes, access to capital, and activities.

- **Merger and acquisition method (or transaction method)** is "a method within the market approach whereby pricing multiples are derived from transactions of interests in companies engaged in the same or similar lines of business." AICPA International Glossary (see §18.3). This method is sometimes called the "market data comparable" or "transactional analysis" method.
- **Prior transactions, offers, and buy-sell agreement considerations** apply not only to transactions in the same company but also to transactions with companies involving comparable risks but not necessarily from the same industry or sector.

Each of the above underlying methods compares the company to similar investments that are sold daily on listed stock exchanges or to public and private company acquisitions by applying units of comparison and making adjustments. Multiples of price to earnings, cash flow, gross profit, assets, or revenues are determined for the appropriate comparable companies and applied to the subject business after adjustments.

Factors to be considered in judging whether or not a reasonable basis for comparison exists include the following:

- Sufficient similarity of qualitative and quantitative investment and investor characteristics;
- The extent to which reliable data is known about the transactions in which interests in the companies were bought and sold;
- Whether or not the price paid was in an arm's-length transaction or a forced or distressed sale;
- Whether or not the transaction involved a financial buyer; and
- When the transaction occurred, as factors such as availability of capital may influence prices paid.

"Comparability" is a relative term. Although the data obtained on guideline companies must be relevant, it need not be identical. A potential investor may desire ownership in a company in a particular industry, or group of industries, because of a specific risk profile. This investor may not, however, demand ownership of a specific type of business. Thus, data on companies that are in the general industry of the subject company that display similar characteristics (including risk) may have relevance in the appraisal.

Once data is obtained and analyzed, the application of a market approach is fairly straightforward. The price paid for the specified interest in the guideline company is related to some other aspect of that company, including earnings, book value, net cash flow, and production units, to develop a ratio. This ratio is then applied to the same aspect of the subject company to estimate the value of the interest before any pertinent adjustments.

§18.52 b. When to Use

The market approach is applicable in many appraisal situations, assuming data is obtainable and accurate. The approach may be applied on both a debt-free (enterprise) basis and an equity (enterprise value less interest-bearing debt) basis. It may be used to value a minority interest or a controlling interest and can be applied to a wide array of operating businesses, from professional practices to highly capital-intensive enterprises.

NOTE™ Conceptually, the market approach is one of the strongest and most appealing techniques for valuing closely held stock, because it reflects actual arm's-length transactions.

Comparing transactions in companies deemed comparable to the company involved addresses the market's perception of risk, required return, anticipated industry growth, and other factors. Factors such as industry consolidation or expansion, which can significantly affect value, are often quantified in monetary terms through an analysis of prices paid for similar companies in the market.

§18.53 c. Disadvantages

The market approach has its disadvantages. Closely held companies generally do not publish data with respect to their financial and operating characteristics. If data regarding the operations of an entity is limited, it may not be possible to determine the entity's comparability. On the other hand, sufficient data may be available regarding the comparability of similar companies, but there may be insufficient detailed data available on the transactions involving these companies. For these reasons, the market approach is often difficult to apply and sometimes unreliable.

§18.54 d. Common Errors

Counsel should be aware of some common errors made by business valuation experts using the market approach:

- Failure to consider and account for differences in the overall market (*e.g.*, comparing companies in the public market to small closely held entities that have no prospect of going public);
- Failure to determine the contents of the results generated from the application of the multiple (*e.g.*, a price-to-gross-revenue multiple from a brokerage database may value fixed and intangible assets only, not the net equity);
- Failure to sufficiently analyze comparability in terms of both company and industry characteristics;
- Failure to address differences in capital structure between the company being valued and a comparable company;
- Failure to account for differences in growth prospects between the company being valued and a comparable company;
- Failure to address qualitative differences between the company being valued and a comparable company, such as position in market, condition of equipment, lease terms, financing, and capital structure;
- Failure to consider liquidation value as a floor value for the company;
- Failure to identify, value, and add back excess or nonoperating assets to the resulting value of the earnings approach;
- Failure to adjust the earnings stream for income and expenses associated with excess or nonoperating assets;
- Failure to consider and account for much larger revenues and much larger diversity of revenues, which is common when comparing most public companies with most small, local, closely held companies; and
- Failure to account for profitability differences.

Business valuation experts will need to examine both nonfinancial and financial information in detail to determine comparability to market transactions. When using the market approach, the business valuation expert may need to adjust the subject company's financial data to facilitate comparability with companies that sold on the open market.

§18.55 3. Income Approach

The "income approach" to valuation is defined as (AICPA International Glossary; see §18.3)

> a general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated economic benefits into a present single amount.

Converting a business's projected flow of income into its present value, *i.e.*, "capitalizing the income," is alternatively known as the "income-based approach," the "discounted future earnings approach," or the "capitalization of cash flow approach" (or a number of other variations).

The income approach seeks to determine the value of a company by assessing the present value of its anticipated future earnings. The terms "economic benefits," "earnings stream," "benefits stream," and "earnings" are commonly used interchangeably. The business valuation expert can use either expected earnings in the next year (single period) or projected earnings in the future (multi-period).

Net cash flow is related to, but distinct from, earnings. While the terms are sometimes erroneously used interchangeably, there are important differences. Net cash flow amounts are not always obvious from the financial statements or tax returns of a business. The business valuation expert usually determines the net cash flows by analyzing both financial and nonfinancial information provided. Net cash flow is the preferred stream because it represents the cash that is available to distribute to the owners or for use by the owners on a discretionary basis without affecting the ongoing operations of the business. Essentially, net cash flows represent a dividend (plus recognized capital appreciation) return to investors. Another reason the net cash flow approach is desirable to the business valuation expert is that empirical data used to estimate risk is based on the cash returns available to the investor of publicly traded companies.

NOTE™ The following formula is used to calculate the net cash flows to equity:

	Net income before taxes
+	Noncash expenses
+	Owner's compensation
+	Perquisites
+	Nonrecurring expenses and nonoperating expenses
-	Nonoperating revenues
-	Replacement value for owner's services
-	Estimated entity-level taxes
-	Capital expenditures (only to support expected level of operations)
-	Additions to net working capital (only to support expected

	level of operations)
+ or −	Changes in long-term debt
=	**Net cash flow to equity**

Risk represents the uncertainty of receiving the expected returns. In the context of the income approach, risk is quantified as a premium to or excess above the risk-free capitalization (or discount) rate. The "cost of capital" is "the expected rate of return that the market requires in order to attract funds to a particular investment." AICPA International Glossary (see §18.3). The cost of capital is usually expressed as a percentage, called the "discount rate." This risk is quantified in terms of the discount rate that is used to convert projected earnings streams to value.

PRACTICE TIP™ It is extremely important that the business valuation expert indicate what economic benefit he or she will be using and which risk procedure(s) will be applied.

EXAMPLE™ Assume a Treasury rate is a "risk-free" rate to the investor (if the United States government defaults, all U.S. currency is worthless). If a large solvent company (*e.g.,* Exxon-Mobil) must borrow money, it will have a risk of default in excess of the Treasury's risk of default. It will therefore pay more (in interest expense) for its cost of borrowing funds. The difference between the Treasury rate and Exxon-Mobil's cost of funds rate can be considered the rate representing the investor public's perception of its risk of default. The total cost of funds (over a specified term, *e.g.,* 5 years) for a company like Exxon-Mobil would be considered its discount rate.

If a single-period model is used (*e.g.,* consideration of the past 5 years), the discount rate is converted to a capitalization rate by deducting the likely long-term sustainable growth rate. This rate is used as a divisor in converting a single, fixed income stream into value. The discount rate is "a rate of return used to convert a future monetary sum into present value." AICPA International Glossary (see §18.3).

Business valuation theory under the income-based approach incorporates the financial theories described above to derive value under several commonly used methods. At the core of income-based methods is this formula:

value = benefits / risk

Two commonly used methods for valuing businesses under the income-based approach are discussed briefly below:

- The capitalization of earnings method (*e.g.,* net cash flows or earnings) (see §§18.56–18.59); and
- The discounted future earnings or cash flow method (see §§18.60–18.62).

§18.56 a. Capitalization of Earnings Method

The "capitalization of earnings method" (also known as the "capitalization of benefit method") of valuation is "a method within the income approach whereby economic benefits for a representative single period are converted to value through division by a capitalization rate." AICPA International Glossary (see §18.3). A commonly used term for this method in general is a "single-period method." Net cash flows are the preferred economic benefit stream, but other earnings streams may be used if properly matched with an adjusted capitalization rate.

Single-period earnings approaches are generally useful to assess the value of mature or stable operating companies because substantial change in growth is not anticipated. Stability in terms of growth, capital structure, and capital expenditures is generally a prerequisite for reliance on this approach.

§18.57 (1) Advantages

The primary advantage of a single-period earnings approach is its simplicity and reliance on actual, historical results as a primary indicator of future operations. The use of a single, constant rate of growth applied to some estimate of future earnings, which is based on past earnings as opposed to varying forecasts of operations, has particular appeal in settings such as family law litigation.

§18.58 (2) Disadvantages

Single-period capitalization of benefits methods also have disadvantages. The single-period model is, by design, quite limiting. Many variables can affect growth or cause fluctuations in the earnings stream. Although sales may be predictable with some accuracy and stability, capital expenditures may fluctuate significantly. If capital expenditures are stable, the company may be highly leveraged and have substantial debt service over the short term. Although balance sheet components may be stable, sales growth may be projected at higher rates over the short term, leveling out in 4 to 5 years. For these and other reasons, the single-period approach should be used with caution and only when it is truly applicable.

§18.59 (3) Common Errors

Counsel should be aware of some of the common errors made by business valuation experts in employing the single-period capitalization of benefits methods:

- Failure to consider growth in the single-period income stream;
- Blind reliance on some average of past results;
- Failure to consider capacity or lack of capacity;
- Failure to consider capital requirements or debt service needs;
- Use of a capitalization rate that does not correspond to the income stream;
- Clear bias in selection of a capitalization rate;
- Use of a capitalization rate that is not supported by the market;
- Failure to consider inflation as a growth factor when using nominal rates;
- Failure to consider liquidation value as a floor value for the entity;
- Failure to analyze lease terms and other relevant factors in determining the duration of the income stream;
- Failure to identify, value, and add back excess or nonoperating assets to the resulting value of the earnings stream; and
- Failure to adjust the earnings stream for income and expenses associated with excess or nonoperating assets.

§18.60 b. Discounted Future Earnings Method

The "discounted future earnings method" (or "discounted future benefits method" or "discounted cash flow method") of valuation is "a method within the income approach whereby the present value of future expected benefits is calculated using a discount rate." AICPA International Glossary (see §18.3). A commonly used term for this method in general is a "multi-period method." Discounted future earnings methods (or multi-period methods) have advantages over single-period methods because they provide maximum flexibility in reflecting and accounting for the various factors that affect the earnings stream. By requiring detailed projections, multi-year methods force the business valuation analyst to consider the effect of all aspects of the operation, which are sometimes ignored by less experienced business valuation experts.

Typically, a business valuation expert uses a 5-year forecast. The period may be longer if it is anticipated that the business's growth will take longer to stabilize or shorter if forecasting becomes improbable for longer periods. At the end of the projection period, the business valuation expert calculates a residual value in order to convert the expected benefits into a present value. "Residual value" or "terminal value" is defined as "the value at the end of the discrete projection period in a discounted future earnings model" and can often reflect the majority of the value. See AICPA International Glossary (see §18.3).

§18.61 (1) When to Use; Advantages and Disadvantages

A discounted future earnings method can be applied to most valuations of closely held companies. It embodies the logic used by many acquisition specialists to identify and value target companies. Thus, it is a strong indicator of fair market value, especially when future earnings are expected to be significantly different from past earnings.

The discounted future earnings method also has disadvantages. The approach is considered speculative by some individuals when litigation is involved. Additionally, the use of the method requires an experienced business valuation expert who is familiar with computer modeling, finance, accounting, tax, and valuation theory.

§18.62 (2) Common Errors

Counsel should be aware of some common errors made by appraisers in employing discounted future earnings methods:

- Unreasonable growth projections;
- Failure to consider the underlying balance sheet implied by the income projections;
- Failure to properly account for terminal value (*i.e.*, value on termination of the business);
- Failure to consider capacity;
- Failure to consider the effect of capital expenditure and debt service adjustments on income taxes and cash flow;
- Failure to consider capital requirements or debt service needs;
- Utilization of a discount rate that does not correspond to the income stream;

- Clear bias in selection of discount rate;
- Use of discount rate that is not supported by the market;
- Failure to consider inflation as a growth factor in projecting income streams;
- Failure to realize liquidation value as a floor value for the entity;
- Failure to consider lease terms and other relevant factors in the projection of the earnings stream;
- Failure to identify, value, and add back excess or nonoperating assets to the resulting value of the earnings approach; and
- Failure to adjust the earnings stream for income and expenses associated with excess or nonoperating assets.

§18.63 VI. VALUATION PREMIUMS AND DISCOUNTS

In calculating the fair market value of a business, certain valuation adjustments can be made that are either premiums (increases in value) or discounts (reductions in value). Taxpayers and the IRS often disagree about the effect of certain valuation premiums and discounts, and numerous cases have discussed the effect of different factors on the amount of a premium or discount. The typical adjustments usually result from

- The degree of control or lack of control the person has over the business (see §§18.64–18.69); and
- The degree of illiquidity, marketability, or lack of marketability of the subject business (see §§18.70–18.73).

NOTE™ Discounts for lack of marketability and lack of control are conceptually distinct. In the context of closely held corporate stock, the minority shareholder discount is designed to reflect the decreased value of shares that do not convey control of a closely held corporation. The lack-of-marketability discount, on the other hand, is designed to reflect the fact that there is no ready market for shares in a closely held corporation. *Estate of Cyril I. Magnin*, TC Memo 2001–31.

§18.64 A. Valuation Premiums

In some situations, the fair market value of an interest in a business entity includes a valuation premium because the interest is a controlling interest or a minority interest with the potential of control. These valuation premiums are generally called

- The control premium (see §18.65); and
- The swing vote premium (see §18.66).

§18.65 1. Control Premium

The control premium reflects the notion that a willing buyer will pay more for a controlling interest in an entity. In *Estate of Simplot v Commissioner* (9th Cir 2001) 249 F3d 1191, the Ninth Circuit implicitly acknowledged the concept of a control premium but held that even a controlling block of stock is not to be valued at a premium for estate tax purposes, unless the IRS Commissioner can show that a purchaser would be able to use the control in such a way as to ensure an increased economic advantage worth

paying a premium. To some extent, the control premium is simply the converse of the minority discount; just as discounts apply to noncontrolling interests, a control premium may apply to a controlling interest in a family business entity.

A discount may be appropriate when a person dies holding a fractional interest in property because the lack of control decreases the property's value. Whether the property should be valued as a whole or as separate fractional interests depends on when the interests are separated. If ownership is split during the decedent's lifetime, the interest the decedent retained is valued separately, while if the split occurs only at death, the property is valued as a whole without a discount. *Estate of Axel O. Adler*, TC Memo 2011–28 (no fractional interest valuation discount allowed for property that decedent deeded to multiple grantees subject to reservation of life estate that caused property to be included in his estate).

§18.66 2. Swing Vote Premium

A variation of the control premium is the swing vote premium, which adds value to a minority voting interest that has swing vote potential. The basis of the swing vote premium is that the owner of a minority voting interest has the potential to combine with other interest holders to gain majority voting control of the entity. See, *e.g.*, *Estate of Clara S. Roeder Winkler*, TC Memo 1989–231 (5-percent swing vote premium allowed). Conversely, a lack-of-control discount may be allowed for nonvoting interests in an entity. In *Estate of Winkler*, there was a 50-percent block, a 40-percent block, and the decedent's 10-percent block. The court found additional value in the 10-percent block because a hypothetical buyer of that block could combine with one of the other two shareholders to either gain or block control of the company. However, in *Estate of Cyril I. Magnin*, TC Memo 2001–31, no swing vote premium was allowed because it could not be shown that a hypothetical buyer could combine with another shareholder and gain control.

For the swing vote premium to apply, the holdings of all the owners must be considered. For example, in IRS Letter Ruling 9436005, the IRS asserted that an increase in value (or at least a reduction in the minority interest discount) had to be applied to a block of shares that had swing vote potential. In this ruling, the donor had made a gift of 30-percent interests in a closely held corporation to each of his three children. The IRS ruled that the value of each gift was enhanced by the simultaneous transfers because any two of the donees could join and control the corporation. The position taken by the IRS does not really conflict with its position in Rev Rul 93–12, 1993–1 Cum Bull 202, in which a donor simultaneously gave five 20-percent interests to his five children. See §18.67. This ruling is generally cited as holding that minority discounts are allowed for intrafamily gifts of minority interests. However, IRS Letter Ruling 9436005 stated that Rev Rul 93–12, 1993–1 Cum Bull 202, merely held that "a minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held by other family members, would be part of a controlling interest."

EXAMPLE™ If a parent-owner makes a single gift of 30 percent to a child, the gift interest has no swing vote attribute, and the normal discount is appropriate. However, if the same owner gives another 30-percent interest the next year to a second child, the IRS states that the second 30-percent gift carries with it swing vote characteristics and the first donee's 30-percent block increases in value because the second 30-percent transfer enhances its voting control by indirectly conferring on it a swing vote element. Thus, it would reduce or eliminate the discount.

B. Discounts for Lack of Control

§18.67 1. Minority or Noncontrolling Interest Generally

The fair market value of a minority or noncontrolling interest in a closely held entity, whether a limited partnership, LLC, or corporation, is usually less than the corresponding proportionate share of the value of the entity. See *Estate of Bright v U.S.* (5th Cir 1981) 658 F2d 999; *Virginia Z. Harwood* (1984) 82 TC 239, aff'd (9th Cir 1986) 786 F2d 1174 (unpublished opinion), cert denied (1986) 479 US 1007; *Estate of Woodbury G. Andrews* (1982) 79 TC 938, superseded by statute on other grounds as stated in *Eisenberg v Commissioner* (2d Cir 1998) 155 F3d 50, 57, acq 1999–1 Cum Bull 332. In general, interests in closely held businesses are allowed valuation discounts in recognition of the minority shareholder's lack of control over the operation and financial performance of the company. Minority interest holders are at a disadvantage in appointing management by virtue of their smaller or nonexistent voting power. Because management can control the way the funds of the company are spent, it can directly control the profitability of the company. Further, since the distributions to be paid depend on the profitability of the enterprise, the controlling shareholder(s) can control the dividends or distributions paid.

NOTE™ The appropriate amount of a minority interest discount varies according to the facts and circumstances of each transfer. Discounts in the range of 15 to 40 percent are commonly recognized. The manner in which the valuation expert provides empirical support to the "level" of the noncontrolling impairment is often the driver for the acceptance of the discount.

Previously, the position of the IRS had been that when voting control exists within a family unit, intrafamily transfers of stock are not entitled to minority interest discounts. See *U.S. v Byrum* (1972) 408 US 125, 33 L Ed 2d 238, 92 S Ct 2382. To some extent, IRS complaints about valuation discounts applicable to family business entities have focused on the perception that a family will act together and that if control is held in the family unit, discounts are illusory (this argument underlies the IRC Chapter 14 rules (IRC §§2701–2704); see §§18.80–18.99).

However, after a number of defeats in the courts, the IRS issued Rev Rul 93–12, 1993–1 Cum Bull 202, in which it conceded that the value of an intrafamily gift of a minority interest in a corporation is determined by looking only at the interest transferred and not by aggregating the voting power held by all family members. In Rev Rul 93–12, the father, owning 100 percent of the stock in a corporation, transferred 20 percent of the shares to each of his five children. Under its "family attribution" theory, the IRS had long argued that family members could be expected to act in concert; that no minority discount should be recognized because the family continued to hold a majority of the shares; and that control premiums should be applied. In this "throwing in the towel" ruling, the IRS, conceding its inability to persuade the courts, announced that it would no longer assert its family attribution theory.

NOTE™ It is important to understand the levels of control that begin with governance, operating authority, voting rights, and economic rights but without voting authority.

§18.68 2. Factors Influencing Level of Discount

The factors influencing the level of a discount for lack of control are based on considerations from the standpoint of the investor. If the interest valued is noncontrolling, the following investor risks, restrictions, and limitations may exist to further increase the available discount:

- Restrictions on access to information;

- Size and type of other equity holders;
- Restrictions on the ability to withdraw or make a public offering;
- Restrictions on access to assets or to make capital contributions;
- Restrictions on management;
- Restrictions on distributions; and
- Restrictions on voting rights.

§18.69 3. Discount Guidelines

Business valuation methodologies and concepts are sometimes challenged by the courts that provide guidelines for accepted discounts. See, *e.g.*, *Peter S. Peracchio*, TC Memo 2003–280 (allowing 15-percent minority interest discount and 24-percent marketability discount for gifts of interests in family limited partnerships (FLPs) holding real estate and marketable securities); *Clarissa W. Lappo*, TC Memo 2003–258 (allowing 6-percent minority interest discount and 25-percent lack-of-marketability discount for FLP funded with cash, money market funds, and publicly traded securities). In *Estate of Helen A. Deputy*, TC Memo 2003–176, the court used "as a guide" a six-factor "matrix" that attempts to calculate a combined marketability and minority interest discount by, in effect, weighting the six factors:

(1) Quality and reliability of the company financial information available to the buyer;

(2) Size of the investment (reflecting the assumption that the more the purchaser must invest, the higher the discount);

(3) Financial outlook, management, and growth potential;

(4) Ability to control the business;

(5) Restrictions on transfer and anticipated holding period; and

(6) Dividend history.

The court rejected the estate expert's use of his own matrix, which had led to a conclusion that a 44-percent discount was appropriate, but nevertheless used the listed considerations as a guide in determining the 30-percent discount.

PRACTICE TIP™ Practitioners should be aware of the developing case law and, perhaps more importantly, choose business valuation experts who are willing to adapt to these changing conditions.

§18.70 C. Discounts for Lack of Marketability

"Marketability" can be defined as the ability to convert property into cash quickly, at minimal cost, and with a high degree of certainty of realizing the expected amount of proceeds from a sale. The discount for lack of marketability is based on the general absence of a ready market for interests in closely held entities. See *Adams v U.S.* (5th Cir 2000) 218 F3d 383; *Estate of Woodbury G. Andrews* (1982) 79 TC 938, superseded by statute on other grounds as stated in *Eisenberg v Commissioner* (2d Cir 1998) 155 F3d 50, 57, acq 1999–1 Cum Bull 332. This discount should apply even to a controlling owner if the assets of the entity are not liquid or are otherwise difficult to sell. *Temple v U.S.* (ED Tex 2006) 423 F Supp 2d 605 (60-percent discount allowed for gift of 76.6-percent interest in LLC that owned and operated ranch; interest held power to dissolve LLC, but court concluded there was no assurance that

dissolution would result in sale of ranch rather than distribution of tenancy-in-common interests in property that could not be partitioned); *Estate of Charles Russell Bennett,* TC Memo 1993–34; *Estate of Gregg Maxcy,* TC Memo 1969–158, rev'd on other grounds (5th Cir 1971) 441 F2d 192. The IRS, however, may challenge a discount if the controlling owner can force a liquidation of the entity and if the assets of the entity are liquid assets. *Adams v U.S., supra*. Quantifying and substantiating the discount for gift and estate tax purposes will generally require a business valuation report.

Appraisers may increase the lack of marketability discount for other characteristics, such as poor portfolio diversity. Courts have allowed additional discounts in valuing the stock of corporations owning assets having a low income-tax basis. See, *e.g., Eisenberg v Commissioner* (2d Cir 1998) 155 F3d 50, acq 1999–1 Cum Bull 332; *Estate of Artemus D. Davis* (1998) 110 TC 530. See also *Estate of Jelke v Commissioner* (11th Cir 2007) 507 F3d 1317, cert denied (2008) __ US __, 172 L Ed 2d 43, 129 S Ct 168; *Estate of Dunn v Commissioner* (5th Cir 2002) 301 F3d 339; *Estate of Jameson v Commissioner* (5th Cir 2001) 267 F3d 366; *Estate of Marie J. Jensen*, TC Memo 2010–182. The Tax Court has also allowed for valuation discounts of interests in properly formed single-member LLCs (which under the check-the-box regulations can be disregarded for federal tax purposes) when the actual interest in the entity is valued, as opposed to the valuation of such entity's underlying assets, once such interests have been gifted or sold. See *Suzanne J. Pierre* (2009) 133 TC 24, discussed in §18.98.

§18.71 1. Business Factors When Calculating Marketability Discount

The following factors are not exclusive but do outline considerations that should assist parties in determining (1) the existence and size of impairments associated with illiquidity and lack-of-marketability discounts and (2) when a lack-of-marketability discount may be warranted:

- **Revenues, earnings, and capitalization size, and volatility of this data.** Lower revenues, less profits or profit history, smaller companies, and industries that are more risky (such as technology) will tend to result in higher discounts.
- **Present, historic, and future assets, revenues, earnings, and profitability.** Companies with a longer history of growth and a likely future of continued growth will tend to have lower discounts.
- **Credit risk, access to ready capital, and existing debt or leverage.** Companies that tend to exceed optimal levels of debt tend to have higher discounts.
- **Access to an active market and "exchange listing"** (*e.g.,* closely held, OTC, NYSE). A smaller pool of buyers or stock that is thinly traded, if at all, will lead to higher discounts.
- **Record of earnings distributions and share redemption.** Higher return on investment and more frequent and higher level of distributions received during the holding period will result in lower discounts.
- **Investor sophistication and existence of agreements, restrictions, or contracts affecting the right to freely transfer shares.** More restrictive shareholder rights and limitations on transfer will result in greater discounts.
- **Risk requirements of investor based on market alternatives and securities laws** (*e.g.,* Regulation D rules, California "merit review" requirements). The greater the return on alternative investments with same or lower risk and restrictions, the higher the discounts.

- **Evidence of mean discounts from empirical studies.** Discounts that share characteristics (*e.g.*, holding period duration, block size, revenues, and other impairments) provide better support for the existence of discounts.
- **Availability of, knowledge of, and access to quality of financial information, size of block, and number of shareholders.** The ease of access to audited financial data and the influence of larger blocks of shares tend to reduce the level of discount.
- **Pool of available buyers.** The smaller the pool of available buyers, the greater the discount.
- **Macroeconomic conditions.** Market instability will tend to create greater risk for a longer holding period with no guarantee that controlling shareholders will automatically seek to liquidate to minimize the loss of value or know when the optimal value is reached to effect a sale.
- **Volume of comparable private transactions.** The less frequently transactions occur for a similar interest, the greater the likelihood of a discount.
- **Desirability of the business by industry type and risk of no sale.** Selling smaller closely held businesses can be problematic, with certain industries less likely to find a buyer depending on revenue size and profitability. The less desirable the characteristics, the greater the discount. However, these less desirable characteristics must not be double-counted in the discount rate under the income approach (see §§18.55–18.59).
- **Contingent liabilities** (*e.g.*, embedded capital gains or pending litigation). The existence of tax liabilities, the absence of key life insurance and disability coverage, and the existence of litigation tend to increase the level of discounts.
- **Susceptibility to changes in regulations and to market, economic, and industry volatility.** Companies more actively regulated and industries more susceptible to marketplace volatility will have greater discounts.
- **Period to market and sell the enterprise (holding period or "window period") and terms of sale.** The longer the holding and payback period under less favorable terms, the greater the discount.
- **Company management (may include key personnel and advisers).** The absence of management depth and a continuation plan without an outside advisory group or board tends to increase the discount.
- **Transaction costs** (*e.g.*, brokerage, financial, and legal fees). The greater the costs associated with due diligence, locating financing, and addressing potential disputes with other interest holders, the greater the discounts.

§18.72 2. Representative Cases

Tax Court cases have allowed lack-of-marketability discounts as high as 36 percent. *Estate of Mark S. Gallo*, TC Memo 1985–363. Rates of 10 to 25 percent are more the norm. *Estate of Albert L. Dougherty*, TC Memo 1990–274. Other cases involving discounts for lack of marketability (even when the assets held are fairly liquid or real property) include the following:

- *Estate of Joseph H. Lauder*, TC Memo 1994–527. The court found that a discount of 40 percent was appropriate to reflect the lack of liquidity of the stock, although 90-percent discount proposed by the family was too high.

- *Estate of Mildred Herschede Jung* (1993) 101 TC 412. The Tax Court approved a discount of 35 percent for lack of marketability from various values set forth by a number of business valuation experts.
- *Estate of Marjorie deGreeff Litchfield*, TC Memo 2009–21. The Tax Court confirmed 25- and 20-percent discounts for lack of marketability on two separate minority interests. The case also included discounts for built-in capital gains and lack of control.
- *Estate of Artemus D. Davis* (1998) 110 TC 530. The court approved a 32-percent discount for lack of marketability.
- *Estate of Richie C. Heck*, TC Memo 2002–34. The court approved a 25-percent discount for lack of marketability.
- *Estate of Webster E. Kelley*, TC Memo 2005–235. The court, rejecting both expert reports and on the basis of its own investigation, came to a 23-percent discount for lack of marketability and an additional 12-percent minority discount for a limited partnership interest of more than 98 percent of the company.
- *Okerlund v U.S.* (2002) 53 Fed Cl 341, aff'd *Okerlund v U.S.* (2002) 365 F3d 1044. The court adopted a 40-percent discount for lack of marketability.

§18.73 D. Combining Discounts for Lack of Control and Marketability

Often, both the minority interest discount (see §18.67) and the lack-of-marketability discount (see §§18.70–18.72) apply. See *John R. Moore*, TC Memo 1991–546 (minority interest discount applied to partnership interests). See also *Virginia Z. Harwood* (1984) 82 TC 239, aff'd (9th Cir 1986) 786 F2d 1174 (unpublished opinion), cert denied (1986) 479 US 1007 (50-percent discount for a minority interest, lack of marketability, and restrictions on free transferability of interest). In *McCord v Commissioner* (5th Cir 2006) 461 F3d 614, the court allowed a 10- to 40-percent minority interest discount depending on the type of asset (with a weighted average discount of 15 percent) and a 20-percent marketability discount for gifts of limited partnership interests on the basis of a professional appraisal of the gifted interests that was used to determine the respective percentages of a block of limited partnership interests received by each donee under a "defined-value" gift provision.

NOTE™ The practitioner should not overlook the impact of IRC §§2703–2704 when valuing interests in limited partnerships and closely held businesses. See §§18.81–18.84.

§18.74 E. Other Discounts

Other discounts that may be considered include discounts for embedded capital gain tax liabilities, key person discounts, blockage discounts, and nonvoting discounts. These are briefly addressed in §§18.75–18.79.

§18.75 1. Embedded Capital Gain Discount

The premise of this discount is that if all things were equal, investors would choose the entity that did not currently suffer from a tax liability that would result in lower net proceeds if an underlying asset were sold. In the case of *Estate of Jelke v Commissioner* (11th Cir 2007) 507 F3d 1317, cert denied (2008) ___

US ___, 172 L Ed 2d 43, 129 S Ct 168, the court allowed a dollar-for-dollar reduction of embedded tax liability; however, the holding was premised on the taxpayer's showing that such a gain cannot reasonably be deferred.

The Tax Court has allowed the embedded capital gain discount in other cases, including *Estate of Marjorie deGreeff Litchfield*, TC Memo 2009–21 (authorizing 17.4- and 23.6-percent valuation discounts for built-in capital gain taxes after taking into account assumed rates of asset sales) and *Estate of Dunn v Commissioner* (5th Cir 2002) 301 F3d 339, 343 (requiring that asset-based value provide reduction for capital gains taxes in amount of 34 percent of those gains).

§18.76 2. Key Person Discount

The death or incapacity of a key individual, such as a salesperson who contributes significantly to a company's revenues, an executive with highly specialized skill and knowledge, or a person who is highly sought after because of name and reputation, may warrant an adjustment. This adjustment is supported by studies that examine these impairments and conclude that a discount from 2 to 8 percent and higher may be warranted. However, the adjustment must not be double-counted when evaluating company-specific risk.

§18.77 3. Blockage Discount

A blockage discount refers to difficulty in selling stock because of its size in relation to the market. Occasionally, this discount will overlap with the discount for lack of marketability. In *Jane Z. Astleford*, TC Memo 2008–128, the court allowed for an aggregate discount (including both blockage and lack-of-marketability discounts) and recognized that the market for the business's shares was thin and that a sale of the entire block would dilute the individual shares' value. The court noted that the alternative would have been to dribble the shares over a protracted period so as not to impair the share price, but this procedure would have rendered the share price susceptible to market volatility during the period necessary to absorb all shares.

In *Estate of Georgina T. Gimbel*, TC Memo 2006–270, the court allowed a 14.4-percent discount for restricted shares of a publicly held company to account for Security and Exchange Commission (SEC) regulations that limit the number of restricted shares that could be sold in any 3-month period. See also *Estate of Dorothy B. Foote*, TC Memo 1999–37 (3.3-percent discount for 2.2-percent block of stock in publicly traded company).

§18.78 4. Nonvoting Stock Discounts

All other factors being equal, nonvoting economic rights have less value than their voting counterparts. This differential becomes more prominent when a very small block of shares has almost all voting control. Often the voting block will have a prorata or premium value, and the nonvoting will have some level of discount between 2 percent and 5 percent.

§18.79 F. Documenting Discount

Although it is clear that the lack-of-control discount and the lack-of-marketability discount apply to family business entities, the taxpayer has the burden of showing the amount of the discount. *Estate of*

Edgar A. Berg, TC Memo 1991–279, aff'd in part and rev'd in part on other grounds (8th Cir 1992) 976 F2d 1163. For all practical purposes, the taxpayer must hire a qualified business valuation expert to prove the amount of each discount. Valuations must address and document the particular situation and cannot merely rely on previous cases to establish the amount of discounts. Often, the presence of a report can present significant hurdles to the IRS or establish the bona fide circumstances of a particular transaction. See, *e.g., McCord v Commissioner* (5th Cir 2006) 461 F3d 614 (appraisal of value documenting transfer between charity and children of taxpayers validated).

Courts are not bound to accept the opinion of any expert witness and have shown an increasing tendency to reach conclusions about value using their own analyses. See, *e.g., Holman v Commissioner* (8th Cir 2010) 601 F3d 763. The Tax Court in particular seems willing to substitute its own judgment for that of any business valuation expert, whether for the IRS or for the taxpayer, if the court believes the expert has not properly supported his or her conclusions. See, *e.g., Bernard Mandelbaum*, TC Memo 1995–255, aff'd (3d Cir 1996) 91 F3d 124. In *Mandelbaum*, the court decided that neither the IRS's expert nor the taxpayer's expert had presented a persuasive case. The ruling then set forth a list of ten nonexclusive factors to determine the lack-of-marketability discount for stock of a closely held corporation. Some appraisers have adopted the *Mandelbaum* factors, while others have criticized the court's approach. See *Estate of Josephine T. Thompson*, TC Memo 2004–174, vacated on other grounds (2d Cir 2007) 499 F3d 129, cert denied (2008) 554 US 902 (affirming Tax Court valuation except for double-counting).

NOTE™ Practitioners should carefully review business valuation reports for any factual inaccuracies. Although questioning certain technical issues may be difficult, practitioners should at least ensure that the business valuation expert is analyzing the particular investment attributes in question and not simply reaching an arbitrary conclusion. Practitioners may also want to request that the expert consider the value of limited partnership units without regard to restrictions on transfer contained in the partnership agreement or other governing documents, as a way of taking into account the possible impact of the ruling in *Holman v Commissioner, supra*.

§18.80 VII. IRC CHAPTER 14 VALUATION RULES: IRC §§2701–2704

The special valuation rules of Chapter 14 of the Internal Revenue Code are set forth in IRC §§2701–2704. In general, the Chapter 14 rules attack traditional "estate freeze" techniques, as well as a number of other intrafamily transactions, in which the value of a transferred interest was considered by the IRS to be undervalued for gift and estate tax purposes. The mechanics of Chapter 14 generally involve ignoring certain rights, restrictions, or retained interests when valuing a transferred interest. Despite these rules, however, gifts of interests in family business entities can still be eligible for valuation discounts if the entity is properly structured, the gifted interest is a minority or noncontrolling interest, and the interest has the same economic rights as other interests in the entity.

For decades, taxpayers had used various interests in corporate entities to attempt to shift some portion of the value of a group of assets to younger generations. These transactions were generally referred to as "estate freeze" transactions because the goal often was to shift all future appreciation to the younger generation while keeping a significant income interest for the older generation. A common approach was to issue preferred stock to the older generation and common stock to the younger generation. The preferred stock retained preferred distribution, liquidation, and voting rights, while the common stock had

all the rights to appreciation. Usually, the common stock was valued at a very low percentage of the value of the entire entity.

Another approach was to transfer all rights except the right to vote. In *Byrum v U.S.* (SD Ohio 1970) 311 F Supp 892, aff'd (6th Cir 1971) 440 F2d 949, aff'd (1972) 408 US 125, the district court held that the taxpayer's retention of the right to vote transferred shares was not a retention of the entire value of the shares for estate tax purposes. The IRS had asserted that retaining the right to vote was an impermissible retained interest under IRC §2036(a). In response to the *Byrum* decision, Congress enacted IRC §2036(b), which provides that retention of the right to vote shares in a controlled corporation (defined in IRC §2036(b)(2) as ownership by the decedent of at least 20 percent of the voting stock) will be considered a retained interest that causes the value of the shares to be included in the transferor's estate. Enactment of this subsection, however, did not stop the use of numerous other estate freeze techniques.

§18.81 A. Interests in Corporations and Partnerships (IRC §2701)

Internal Revenue Code §2701 applies to the valuation of interests in corporations, partnerships, and, by extension, LLCs. It generally seeks to prevent a low valuation of intrafamily transfers of these interests to a younger generation when the older generation retains preferred interests with certain distribution, liquidation, put, call, or conversion rights. Such a retained interest is called an "applicable retained interest." See IRC §2701(b); Treas Reg §25.2701–2(b)(1). Unless certain requirements are met, the value of an applicable retained interest is deemed to be zero and the value of the transferred interests will equal the value of the entire entity.

To be considered to have value, a retained interest must have a "qualified payment right." A qualified payment right requires actual payments to be made at least annually, at a fixed rate or amount, with an interest penalty attached if the payments are not made. See IRC §2701(c)(3); Treas Reg §25.2701–2(b)(6).

CAUTION™ The cash flow requirement to make the payment is unrelenting and generally makes operating within this rule unattractive.

Internal Revenue Code §2701 does not apply when (IRC §2701(a)(1)–(2); Treas Reg §25.2701–1(c)–(d)) in any of the following circumstances:

- Readily available market quotations exist to value a transferred interest or an applicable retained interest;
- The retained interest is of the same class, or proportionally the same, as the transferred interest;
- The transfer proportionately reduces each class of interest held by the donor, the donor's spouse, and their ancestors in the aggregate; or
- A corporation, partnership, or LLC has only one class of outstanding stock or interests.

For further discussion of IRC §2701, see California Estate Planning, chap 25 (Cal CEB 2002).

§18.82 B. Interests in Trusts (IRC §2702)

Internal Revenue Code §2702 generally applies to interests in trusts or trust-like arrangements in which the grantor has a retained interest and has made a gift of an interest in the trust to family members. As in IRC §2701, unless certain requirements are met, the value of a retained interest that is not a qualified

interest is deemed to be zero for gift tax purposes. IRC §2702(a)(2). Thus, the value of the gift would be the entire value of the property transferred to the trust.

NOTE™ A qualified personal residence trust (QPRT) that allows the grantor to continue living in his or her residence for a specified term following transfer of the residence to the trust is excepted from this rule. IRC §2702(a)–(b). Further, the continued use of a grantor retained annuity trust (GRAT) and grantor retained unitrust (GRUT) is permissible under §2702. In general, GRATs and GRUTs can provide transfer tax savings if the grantor outlives the term of the trust and if the underlying property appreciates at a rate higher than the applicable federal rate under IRC §7520, which is used to value the remainder interest for gift tax purposes at the time the trust is created. Treas Reg §25.2702–2(b). On the use of GRATs in business succession plans, see chap 8.

§18.83 C. Agreements Among Family Members (IRC §2703)

Internal Revenue Code §2703 applies to agreements among family members involving (1) rights to acquire or use property at a price less than the fair market value of the property or (2) restrictions on the right to sell or use property. The rights or restrictions may be contained in options; buy-sell agreements; partnership, operating, or shareholders' agreements; or any other agreement. These rights or restrictions will be disregarded in valuing the transferred property for transfer tax purposes unless the option, agreement, right, or restriction meets the following requirements (IRC §2703(b)):

- It is a bona fide business arrangement;
- It is not a device to pass on wealth to members of the decedent's family at a reduced value; and
- Its terms are comparable to similar agreements among unrelated persons in arm's-length transactions.

Thus, for example, in *Fisher v U.S.* (SD Ind, Sept. 1, 2010, No. 1:08-cv-0908-LJM-TAB) 2010 US Dist Lexis 91423, the court held that transfer restrictions on a parcel of undeveloped real property in a family limited liability company (FLLC) should be disregarded because the FLLC did not have a bona fide business purpose. The court determined the FLLC was not engaged in the business of real estate investment or development because there was no evidence that its members made any investment in the property to increase its commercial value or that they tried to acquire additional real property as an investment for the FLLC.

NOTE™ Although an option or buy-sell agreement among unrelated parties can reduce the value of property for estate tax purposes, such an agreement among family members could not do so even before the enactment of IRC §2703, unless the agreement met certain requirements set forth in Treas Reg §20.2031–2(h) and case law. Under the regulation and case law, to avoid being disregarded in valuing property, buy-sell agreements had to meet the first two requirements of §2703, *i.e.*, be a bona fide business arrangement and not be a device to pass on wealth at a reduced value. Many planners believed that the third requirement in §2703 (comparability of terms) would be almost impossible to meet. See *Holman v Commissioner* (8th Cir 2010) 601 F3d 763 (IRS expert viewed terms of agreement as not comparable to similar arrangements entered into in arm's-length transactions, because no one would enter into such an agreement at arm's length). See also §18.92.

§18.84 D. Lapsing Rights and Restrictions (IRC §2704)

Internal Revenue Code §2704 concerns the treatment for gift and estate tax purposes of (1) lapses of voting or liquidation rights and (2) transfers of interests with liquidation restrictions. A thorough understanding of this section is critical to the proper structuring of family business entities for gift and estate tax valuation purposes.

§18.85 1. IRC §2704(a)

In general, IRC §2704(a) treats the lapse of voting or liquidation rights in a business entity as either a transfer by gift or a transfer includable in the decedent's gross estate, depending on when the lapse occurs. This section applies only if the individual with the rights and his or her family (as defined in IRC §2704(c)(2)) control the entity both before and after the lapse. Control is based on ownership of at least a 50-percent interest in the entity. IRC §§2701(b)(2), 2704(c)(1); Treas Reg §25.2701–2(b)(5).

The effect of §2704(a), if it applies, will often be to eliminate the discounts for minority interest or lack of marketability, or both. This rule prevents a reduction in the value of interests in closely held entities transferred by a donor whose retained interests have voting or liquidation rights that lapse after the transfer. This statute was enacted in response to *Estate of Daniel J. Harrison, Jr.*, TC Memo 1987–8, in which the decedent's right to force liquidation lapsed at death and the right was not taken into account in determining the value of the estate.

Generally, §2704(a) will not apply if an individual does not possess a voting or liquidation right. As a result, this section should be relatively easy to plan around.

§18.86 2. IRC §2704(b)

In planning for valuation discounts, IRC §2704(b) is probably more troublesome than IRC §2704(a). Subsection (b) provides that for purposes of valuing a family business interest that is transferred to a member of the transferor's family, any "applicable restriction" will be disregarded to the extent that it is more restrictive than the limitations that would apply under federal or state law in the absence of the restriction. IRC §2704(b)(3)(B); Treas Reg §25.2704–2(b). An "applicable restriction" is one that restricts an entity's ability to liquidate and either lapses in whole or in part after the transfer or can be removed in whole or in part by the transferor or any member of the transferor's family, either alone or collectively. IRC §2704(b)(2).

Section 2704(b) applies only if the transferor and his or her family (as defined in IRC §2704(c)(2)) control the entity before the transfer. Control is based on ownership of at least a 50-percent interest in the entity. IRC §§2701(b)(2), 2704(b), (c)(1); Treas Reg §§25.2701–2(b)(5), 25.2704–2(b). If the holder of the interest would have the right to liquidate the entity under state law absent the applicable restriction, the effect of §2704(b) will be to eliminate entity-level valuation discounts.

§18.87 3. Dissolution

Except as otherwise provided in the partnership agreement, a California limited partnership will be dissolved on the approval of all general partners and a majority in interest of the limited partners. Corp C §15908.01(b). Thus, a provision in a California limited partnership agreement requiring the approval of all limited partners to liquidate the partnership (along with the approval of all general partners) would be

an applicable restriction under IRC §2704(b) because the California default rule requires approval of only a majority of the limited partnership interests.

Similarly, the vote of a majority in interest of the members of an LLC will dissolve an LLC, unless a greater percentage of the voting interests is specified in the LLC's articles of organization or operating agreement. Corp C §17350(b). However, any supermajority dissolution requirement in the organizing documents would be treated as an applicable restriction.

California corporations will be dissolved on the vote of shareholders with 50 percent or more of the voting power. Corp C §1900(a). This percentage cannot be reduced.

§18.88 E. IRS Attacks on Valuation Discounts

The IRS has consistently attacked the valuation discounts that practitioners have asserted for partnerships and other closely held enterprises, especially when the enterprises are not traditional businesses. See, *e.g.*, IRS Letter Rulings 9723009, 9725002, 9730004, 9842003, citing *Estate of Elizabeth B. Murphy*, TC Memo 1990–472. In *Estate of Murphy*, 18 days before dying, the decedent gave about 2 percent of her stock in a closely held corporation to her children, reducing her 51-percent controlling interest to a 49-percent minority interest. The court held that a minority discount could not be applied, because the sole purpose and effect of fragmenting the control block of stock was to reduce federal tax. The court stated that nothing of substance was intended to change as a result of the transfers, and the gifts did not significantly affect the decedent's beneficial interest except to reduce estate taxes.

In Field Service Advice 200143004, the IRS, despite a number of defeats in the courts, reasserted several arguments against valuation discounts in family-owned entities, as follows:

- The entity lacks economic substance and should be disregarded for gift or estate tax purposes (a substance-over-form argument);
- Internal Revenue Code §2703 requires all family business entities to be ignored for valuation purposes;
- Any restriction in excess of restrictions applicable under state law should be ignored for valuation purposes under IRC §2704(b);
- The assets of the entity are included in the estate of the transferor under IRC §2036(a);
- A gift can occur on formation of a family limited partnership (FLP) if the total value of all partnership interests, valued individually, is not equal to the total value of the underlying property (although the IRS recommended against using this argument in Field Service Advice 200143004, it remains an argument that it may raise); and
- In the alternative, the claimed discounts for lack of control and lack of marketability will be considered excessive in certain cases.

Given IRS antipathy toward the valuation of family business entities, the practitioner should advise clients forming these entities of the risks involved in entering into what the IRS regards as aggressive tax planning. The practitioner should also have a thorough understanding of federal and state laws that affect the existence of this valuation approach. The IRS has achieved the most success in the courts using IRC §2036(a)(1) and, in a surprising turn of events, IRC §2036(a)(2). See §§18.94–18.99.

§18.89 F. Court Responses to IRS Arguments

In a number of cases in which the IRS has challenged valuation discounts on a variety of grounds, the courts have held for the taxpayer and allowed valuation discounts for interests in family business entities for gift and estate tax purposes. However, courts have adjusted the amount of some of the discounts. See §§18.90–18.93.

§18.90 1. IRC §2704(b) Argument

The IRS has argued that the existence of a term in a family limited partnership (FLP) agreement, *i.e.*, a specified date when the entity would dissolve and liquidate, is an applicable restriction under IRC §2704(b) if state law permits a limited partner to withdraw from a limited partnership that does not have a stated term. On the use of FLPs in business succession plans, see chap 15. Similarly, the IRS might argue that an applicable restriction exists for a California limited partnership if the partnership agreement restricts the right of a majority limited partner to remove the general partner.

PRACTICE TIP™ Practitioners with clients who will retain a majority interest in a partnership may wish to consider forming the partnership under the Uniform Limited Partnership Act of 2008 (Re-RULPA) (Corp C §§15900–15912.07) or under the law of another state that also does not give the majority limited partner the right to remove the general partner and that does not give a limited partner the right to dissociate (withdraw) from a partnership that does not have a stated term. See generally Corp C §§15903.01–15903.07, 15906.01(a).

Although two Tax Court cases had held that the IRS could apply the applicable restriction test only to dissolution statutes in determining whether an applicable restriction exists, both cases have ultimately been resolved on other grounds and may no longer be persuasive authority. In *Baine P. Kerr* (1999) 113 TC 449, aff'd (5th Cir 2002) 292 F3d 490, the Fifth Circuit held that IRC §2704(b) did not apply because an unrelated party, the University of Texas, was a limited partner and the family therefore did not control the partnership for purposes of §2704(b). Thus, the question of whether the term limit was an applicable restriction was not reached, and the holding in the Tax Court decision now appears to be simply dictum. In *Estate of Morton B. Harper*, TC Memo 2000–202, the court relied on the Tax Court's holding in *Kerr* in reaching a similar result. However, in *Estate of Morton B. Harper*, TC Memo 2002–121, the court held that IRC §2036(a) applied to the taxpayer. See §18.95. Thus, the result in the first *Harper* decision, although apparently still good law, is now based on dictum in another case and has been rendered moot (although apparently not overruled) by subsequent proceedings in the same case. Although the arguments raised in the two Tax Court cases may still be valid, the issues are far from settled under existing case law.

§18.91 2. Lack of Economic Substance Argument

Another IRS argument is that a family limited partnership (FLP) should be disregarded for federal tax purposes because it lacks economic substance. This argument was dealt a defeat in *Ina F. Knight* (2000) 115 TC 506, in which the Tax Court refused to ignore the existence of an FLP for failure to have economic substance. Instead, the court found that state law governs the existence of property rights, that the partnership was a valid partnership under state law, and that because a potential buyer would not

ignore the partnership, the partnership should be recognized in valuing the partnership interest for federal estate and gift tax purposes.

The Tax Court, however, agreed with the IRS and disallowed a minority interest discount for lack of economic substance in *Estate of Elizabeth B. Murphy,* TC Memo 1990–472. See §18.67. Practitioners should note that the court referred to several writings from the donor's professional advisers exhorting her to make the gift in order to reduce her interest for the purpose of obtaining a minority interest discount. See also *Estate of Theodore R. Thompson,* TC Memo 2002–246, aff'd (3d Cir 2004) 382 F3d 367.

In contrast to *Estate of Murphy,* the tax court did not apply the lack of economic substance argument in *Estate of Anthony J. Frank, Sr.,* TC Memo 1995–132, in which the decedent's son, acting under a power of attorney, made a gift of more than 18 percent of the decedent's stock in a closely held corporation to the decedent's wife just 2 days before the decedent's death. The court ignored the motive for the gift because a much smaller gift would have accomplished the goal if tax avoidance had been the only motive for the gift.

In *Keller v U.S.* (SD Tex, Sept. 14, 2010, No. V-02–62) 2010 US Dist Lexis 95500, the court allowed a claimed $52 million administration expense deduction for interest on a loan to a decedent's estate made by a family limited partnership for purposes of paying the estate tax and preserving the liquidity of the estate. The court held that the loan satisfied the economic substance test.

§18.92 3. IRC §2703 Argument

The IRS has argued that the partnership form itself is the restriction that must be disregarded under IRC §2703 for valuation purposes. This argument was struck down in *Church v U.S.* (WD Tex 2000) 2000–1 USTC ¶60,369, 85 AFTR2d 804, aff'd (5th Cir 2001) 268 F3d 1063 (unpublished opinion), in which the court held that it would not disregard the taxpayer's family limited partnership (FLP), because it was validly formed under state law. See also *Estate of W.W. Jones II* (2001) 116 TC 121. But see *Smith III v U.S.* (WD Pa 2004) 2004–2 USTC ¶60,488, 94 AFTR2d 5283 (FLP agreement provision concerning partnership's right to pay purchase price in installments if it exercises right of first refusal disregarded for valuation purposes unless IRC §2703(b) safe harbor provision applies). The principle was first set forth by the Tax Court in *Estate of Albert Strangi* (2000) 115 TC 478, aff'd in part and rev'd in part on other grounds sub nom *Gulig v Commissioner* (5th Cir 2002) 293 F3d 279 (*Strangi I*), but the court of appeals remanded the case to determine whether IRC §2036(a) applied. On remand, see *Estate of Albert Strangi,* TC Memo 2003–145, aff'd (5th Cir 2005) 417 F3d 468 (*Strangi II*), discussed in §18.95. Thus, the precedential value of *Strangi I* is in question.

At least one court has used §2703 to disregard the valuation of an appraiser who relied on the buy-sell restriction in the partnership agreement in determining the value of a limited partnership interest. See *Smith III v U.S., supra*. Subsequently, in *Holman v Commissioner* (8th Cir 2010) 601 F3d 763, the court found that the buy-sell provisions of a limited partnership agreement operated to restrict the ability of the limited partners (the taxpayers' children) to reach their proportionate share of the underlying value of the partnership. Therefore, the court deemed the buy-sell provisions to be a device to pass wealth to other family members, even though the buyback provisions required the units to be priced at fair market value, and held that the IRS properly ignored the restrictions when valuing the limited partnership units because the values of the interests of the remaining partners would increase if the partnership were to purchase limited partnership units transferred in violation of the agreement. (The IRS expert took the view that the terms of the agreement were not comparable to similar arrangements entered into by persons in arm's-

length transactions for the simple reason that no one would ever enter into the agreement at arm's length.) The court concluded that the restrictions were not part of a "bona fide business arrangement" in any event, as required by IRC §2703(b), because the restrictions were intended to prevent dissipation of property by the limited partners—not to preserve a business. It remains to be seen whether other courts will accept the premise that (1) buy-sell provisions requiring use of fair market value are properly characterized as devices to pass wealth to family members or (2) there is a substantial difference in value when fair market value is the standard in the buy-sell agreement. For further discussion of use of buy-sell agreements in succession planning, see chap 6.

§18.93 4. Lost Value Argument

The Tax Court in *Estate of Albert Strangi* (2000) 115 TC 478, aff'd in part and rev'd in part on other grounds sub nom *Gulig v Commissioner* (5th Cir 2002) 293 F3d 279 (*Strangi I*), invalidated the IRS argument that seeks to find a gift on formation of the family limited partnership (FLP) by arguing that the "lost" value has to go somewhere. The court held that there was no gift on the formation of the partnership, which occurred 2 months before the decedent's death, principally because the decedent received credit for all of his contributions in his capital account with the partnership. See also *Church v U.S.* (WD Tex 2000) 2000–1 USTC ¶60,369, 85 AFTR2d 804, aff'd (5th Cir 2001) 268 F3d 1063 (unpublished opinion); *Estate of W.W. Jones II* (2001) 116 TC 121.

§18.94 G. IRS Litigation Victories Using IRC §2036(a)

Although the IRS has yet to succeed in court on any of its more esoteric theories designed to invalidate all family limited partnerships (FLPs), significant IRS victories under IRC §2036(a) have had a major impact on partnership planning. See *Estate of Albert Strangi*, TC Memo 2003–145, aff'd (5th Cir 2005) 417 F3d 468 (*Strangi II*); *Estate of Wayne C. Bongard* (2005) 124 TC 95 (transfer to partnership ineffective for estate tax purposes).

Section 2036(a) provides that a decedent's gross estate includes any property transferred by the decedent, excluding transfers by bona fide sale for full and adequate consideration, in which the decedent retained either (1) the possession or enjoyment of the property or right to income of the property or (2) the right, alone or in conjunction with any other person, to designate the persons who could possess or enjoy the property or its income. See §18.95. Most planners are now convinced that partnerships should have a legitimate and significant business or nontax purpose. See §18.96. In addition, planners may have to take other measures to lessen the impact of these cases in any partnership in which discounts are desired or gifts are made. See §18.97. Planners also should consider the possible application of the step-transaction doctrine. See §18.98.

PRACTICE TIP™ Whenever a taxpayer will retain any interest in a partnership or other business entity, the practitioner will have to consider the impact of §2036(a). Documenting the nontax purpose promises to be the most effective way to ensure that this section will not be applied. See §18.99.

§18.95 1. Application of IRC §2036(a)(1)–(2)

It has always been clear that IRC §2036(a)(1) applies if the decedent had either an express or implied agreement to retain the enjoyment of property. See *Estate of Roger D. Malkin*, TC Memo 2009–212;

Estate of Erma V. Jorgensen, TC Memo 2009–66; *Estate of Wayne C. Bongard* (2005) 124 TC 95; *Estate of Valeria M. Miller*, TC Memo 2009–119; *Estate of Hilde E. Erickson*, TC Memo 2007–107. However, as a result of the Tax Court opinion in *Estate of Albert Strangi*, TC Memo 2003–145, aff'd (5th Cir 2005) 417 F3d 468 (*Strangi II*), planners must also consider the effect of IRC §2036(a)(2), which was not discussed in the Fifth Circuit decision.

Generally, §2036(a)(2) was thought to be more limited in scope than §2036(a)(1). Before *Strangi II*, it was believed that a general partner's duty to control and manage a partnership was insufficient to cause inclusion, because of the fiduciary duties owed to the limited partners. See *U.S. v Byrum* (1972) 408 US 125, 33 L Ed 2d 238, 92 S Ct 2382. See also IRS Letter Rulings 9415007, 9310039. The Tax Court opinion in *Strangi II* distinguished *Byrum*, stating that the fiduciary duties in *Byrum* were far more significant than the fiduciary duties in *Strangi II*. The Tax Court noted the presence of unrelated shareholders and an independent trustee in *Byrum*, compared with the absence of any non-family members in *Strangi II*, and the fact that Strangi essentially owned all of the partnership. Because Strangi had no meaningful fiduciary duty, the court held that his 47-percent interest in the corporate general partner allowed him (through his attorney-in-fact; Strangi was actually incapacitated at the time), in conjunction with the other shareholders, to control the income of the partnership, thereby justifying inclusion under §2036(a)(2) as well as a retained income interest under §2036(a)(1). (The Tax Court opinion in *Strangi II* also ignored the holding in *Estate of Cohen* (1982) 79 TC 1015, which held that §2036(a)(2) did not apply to trustees of a Massachusetts business trust who had the power to declare dividends.)

After *Strangi II*, and contrary to its holding on this point, the court in *Estate of Anna Mirowski*, TC Memo 2008–74 cited the general partner's fiduciary duties under Maryland law as a reason why §2036(a)(2) did not apply to gifts of limited partnership units made to trusts for the decedent's daughters. See also *Kimbell v U.S.* (5th Cir 2004) 371 F3d 257 (decedent's 50-percent interest in general partner not sufficient to make §2036(a)(2) apply). Neither case discussed the *Strangi II* language concerning intra-family fiduciary duties.

§18.96 2. Significant Nontax or Business Purpose

It appears relatively clear that if a taxpayer establishes a significant nontax or business purpose for the formation of the business entity, IRC §2036 will not apply. See *Estate of Charlene B. Shurtz*, TC Memo 2010–21 (legitimate nontax reasons included protection from risks associated with litigious environment family believed existed in Mississippi and centralization of management for decedent's timber interests); *Estate of Samuel P. Black* (2009) 133 TC 340 (protecting family stock is legitimate nontax motivation); *Estate of Wayne C. Bongard* (2005) 124 TC 95 (one entity had business purposes; another entity did not); *Estate of Valeria M. Miller*, TC Memo 2009–119 (legitimate business purpose found when decedent had actively managed business and retained sufficient assets to provide for living expenses); *Estate of Erma V. Jorgensen*, TC Memo 2009–66 ("buy and hold" strategy for marketable securities was not significant nontax motive; management succession is legitimate nontax purpose only when "active" management required); *Estate of Anna Mirowski*, TC Memo 2008–74 (legitimate nontax purposes included limited liability, centralized management, and providing equally for children); *Estate of Charles Porter Schutt*, TC Memo 2005–126 (significant nontax purpose found when taxpayer wished to avoid diversification of particular publicly traded company's stock); *Estate of Virginia A. Bigelow*, TC Memo 2005–65, aff'd (9th Cir 2007) 503 F3d 955 (no legitimate nontax purpose; gift giving is testamentary in nature and cannot be

legitimate nontax purpose); *Estate of Eugene E. Stone III*, TC Memo 2003–309 (investment and asset management and resolving children's litigation are significant nontax purposes). These courts have held that if a taxpayer has a legitimate nontax purpose, it is a bona fide transfer for adequate consideration on formation of the partnership, thereby precluding the operation of §2036. However, the purpose must be real, not theoretical, and not simply recited in the partnership agreement.

NOTE™ The inquiry into whether a nontax purpose rises to the level required is factual and may turn to some extent on the nature of the underlying assets of the partnership. Operating businesses, agricultural concerns, and rental real property are among the types of assets that are often commonly held in limited partnerships or LLCs to limit liability, regardless of estate tax consequences. As a result, it may be easier to establish legitimate business purposes for entities holding these types of assets.

Several cases have examined limited liability as a legitimate nontax purpose. Although some of the cases have held that the taxpayer did not establish that there was any liability from which protection was needed, none of them held that limiting liability was itself not a legitimate nontax purpose. See *Estate of Virginia A. Bigelow, supra; Estate of Albert Strangi*, TC Memo 2003–145, aff'd (5th Cir 2005) 417 F3d 468 (*Strangi II*). Furthermore, at least two cases have specifically held that limiting liability was a legitimate nontax purpose for the particular taxpayer in question. See *Estate of Anna Mirowski, supra; Kimbell v U.S.* (5th Cir 2004) 371 F3d 257. *Estate of Mirowski* involved partnership-owned patents that may have been subject to litigation, and *Estate of Kimbell* involved partnership-owned oil and gas properties. However, neither opinion clarifies the actual necessity for liability protection. Although risks from liability connected with real property or operating businesses can be protected through insurance, clients are commonly advised to consider limited partnerships and LLCs for additional liability protection. As a result, limiting liability should be a legitimate nontax purpose for these types of assets. See, *e.g.*, *Keller v U.S.* (SD Tex 2009) 2009–2 USTC ¶60,579, 104 AFTR2d 6015 (purpose of protecting assets from divorce was legitimate and satisfied bona fide sale exception of IRS §2036(a)).

PRACTICE TIP™ Regardless of the type of asset, it is good practice to contemporaneously document the client's significant nontax purposes. See *Estate of Erma V. Jorgensen, supra*.

§18.97 3. Other Strategies to Avoid IRC §2036(a)

Strategies exist that might prevent the application of IRC §2036(a)(2) even if a court does not find significant nontax purposes. For example, control over distributions might be given to a general partner other than the taxpayer while allowing the taxpayer to retain input over management issues. It is possible that if other family members have significant ownership interests, fiduciary duties will be recognized, making the application of §2036(a)(2) more difficult. Nevertheless, planners must not only consider strategies designed to highlight these fiduciary duties or isolate control over income but also consider how these strategies can be integrated with the client's nontax goals. In addition, because the courts have treated the transfer of too much of a taxpayer's property to a partnership as evidence of an implied agreement to retain enjoyment, taxpayers undertaking partnership planning should be advised to keep a substantial amount of their assets outside of the partnership and available to support their lifestyles and meet their obligations. See, *e.g.*, *Estate of Virginia A. Bigelow*, TC Memo 2005–65, aff'd (9th Cir 2007) 503 F3d 955. One court has allowed the taxpayer to look at distributions expected from the partnership

that are proportional to the taxpayer's nontransferred interest in determining whether sufficient assets were kept to meet expected obligations. *Estate of Anna Mirowski*, TC Memo 2008–74.

Some practitioners also believe that the right to vote on liquidations is a power, alone or in conjunction with others, to control the income or property of the partnership. Under the Uniform Limited Partnership Act of 2008 (Re-RULPA) (Corp C §§15900–15912.07), it appears that California allows restrictions on a limited partner's right to vote on liquidations. Therefore, if a practitioner believes that this voting right will be characterized as a power to control, the partnership agreement could be drafted to eliminate the right. Again, practitioners will need to consider whether such a provision will serve the client's nontax goals.

In some cases, the IRS may fail to raise the section 2036(a) argument, which has produced at least one unusual result. See *Estate of Webster E. Kelley*, TC Memo 2005–235 (12-percent minority discount and 23-percent marketability discount applied even though only partnership asset was cash).

§18.98 4. Application of Step-Transaction Doctrine

The IRS has successfully applied the step-transaction doctrine to gifts of partnership interests. See *Senda v Commissioner* (8th Cir 2006) 433 F3d 1044. In *Senda*, the court found that the taxpayers made indirect gifts of stock, not gifts of partnership interests, because the transfer of partnership interests was made in an integrated transaction at the same time as the transfer of assets to the partnership. See also *Heckerman v U.S.* (WD Wash 2009) 2009–2 USTC ¶60,578, 104 AFTR2d 5551.

NOTE™ Whether a series of transactions should be "stepped" together and treated as a single transaction generally constitutes a question of fact. However, the proper characterization of a transaction for tax purposes is an issue of law. *Senda*, 433 F3d at 1048. No specific standard has been universally applied in assessing whether a number of separate steps or activities should be viewed as comprising one transaction; however, courts have generally used one of three alternative tests: (1) the "binding commitment" test, (2) the "end result" test, and (3) the "interdependence" test. See *Linton v U.S.* (9th Cir 2011) 630 F3d 1211, 1224.

Some commentators believe the door has been opened for application of the doctrine to a transfer of property to the partnership *followed* by a gift of partnership interests if the two actions are part of a single "integrated transaction." Therefore, to avoid application of the step-transaction doctrine, the practitioner might attempt to make the difficult determination of how long to wait once assets have been transferred to a partnership before gifts or other transfers of partnership interests are made. *Eighth Circuit Decides to Senda Message: Step-Transaction Doctrine Can Apply to FLP Contribution/Gift Transactions*, 27 CEB Est Plan Rep 93 (Feb. 2006). However, fears that the doctrine could be broadly applied in this context may be overblown. See, *e.g.*, *Holman v Commissioner* (8th Cir 2010) 601 F3d 763 (gifts of limited partnership units made 5 days after formation of partnership not subject to step-transaction doctrine because of possible market fluctuations in underlying publicly held stock). However, both *Heckerman v U.S.*, *supra*, and *Linton v U.S.*, *supra*, relied on *Senda* and distinguished *Holman*.

NOTE™ For a case in which application of the step-transaction doctrine was specifically reserved for separate decision, see *Suzanne J. Pierre* (2009) 133 TC 24. In *Pierre*, the court held that gifts of membership interests in a single-member LLC were gifts of LLC interests rather than gifts of the underlying assets of the LLC. The court concluded that state law concepts control the nature of

property interests; therefore, the IRS's disregarded-entity rules applicable to single-member LLCs do not apply for purposes of the federal gift tax.

PRACTICE TIP™ Although *Pierre* is favorable to the taxpayer's position, this was only one Tax Court opinion, and to avoid a challenge by the IRS, the better practice may be to create a two-member LLC (which is not disregarded for federal income tax purposes) by giving away a 1-percent membership to one of the intended beneficiaries. See generally 31 CEB Est Plan Rep 27 (Oct. 2009).

§18.99 5. Planning Responses to IRC §2036(a) Attacks

IRS attacks using IRC §2036(a) have generated extensive discussion among estate planners using partnerships, as well as a number of planning responses. First and foremost, practitioners should realize that partnerships without any serious nontax objectives are unlikely to achieve the desired tax consequences. See §18.96. In addition, practitioners need to counsel clients to take precautions to avoid the more obvious problems highlighted by these cases. Some of the precautions that should be considered are as follows:

- **Avoid disproportionate distributions.** Prorata distributions show that all partners have a stake in the partnership. Disproportionate distributions, especially going back to the original transferor, are strong evidence of an implied agreement that the transferor may retain use of the assets.
- **Retain funds outside partnership for personal use.** The client should retain sufficient assets to completely fund his or her lifestyle. If the client has to rely on the partnership for living expenses, a court may find it very easy to infer that there was an agreement that the funds would be available for that purpose and are therefore an impermissible retained interest.

  NOTE™ Many practitioners believe it should be permissible for the client to rely on his or her *proportionate* share of partnership income for living expenses.

- **Respect partnership formalities.** Obviously, separate partnership accounts and records should be kept. Holding meetings and taking minutes is also probably a good idea. Again, careful practitioners will admonish clients to operate the partnership as a business (even if the business is investing in passive assets) and to avoid using partnership assets for any purpose that does not benefit the partnership.

  PRACTICE TIP™ Contributions of property to a partnership should be properly documented and occur before any transfers of partnership interests.

- **Document business purpose and economic substance.** The partnership's investment policies and activities should be documented. The investment policy should be tailored to the partnership as a whole and not to the original owner, although the continuation of certain family investment values can be a significant nontax purpose. In some cases, the underlying activities will be ongoing businesses, which should easily satisfy the business purpose requirement, especially if the original business was not otherwise in an entity.
- **Isolate control.** The partnership can be structured so that control over distributions is held by someone other than the original owner. For example, in a partnership with two general partners, the second general partner, who should not be the client, could be given exclusive authority over

distributions. This precaution may not be sufficient if the *Strangi II* holding is expanded to cover any situation in which two persons in a partnership (whether limited or general) can somehow combine to make a decision to control income. See *Estate of Albert Strangi*, TC Memo 2003–145, aff'd (5th Cir 2005) 417 F3d 468 (*Strangi II*), discussed in §18.95. Ironically, this precaution might not ordinarily be taken in most business partnerships but might be prudent when the only members of the partnership are related, even if the underlying asset is an ongoing and active business. It may also be prudent to eliminate the right to vote on liquidations for any class of interest that the client will retain.

- **Have all partners contribute.** Having a number of partners contribute more than a de minimis amount at the initial formation of the partnership may help the partnership qualify for the full and adequate consideration exception to IRC §2036(a)(2). From a practical standpoint, having each partner risk some capital should also help indicate that the economic arrangement was a true partnership.
- **Consider transferring all interests.** Although some of the initial appeal of the partnership may have been the ability to retain control, it could make sense for existing partnerships to consider a transfer of all of the donor's interest in the partnership because IRC §2036(a) is an estate tax statute and has no application for gift tax purposes. Practitioners should be careful in these situations, however, to consider the 3-year rule of IRC §2035, which generally applies to gifts of retained interests under §2036(a); as a result, it may be preferable to sell, rather than gift, remaining partnership interests.
- **Consider formula transfers.** In *Estate of Anne Y. Petter*, TC Memo 2009–280, the taxpayer made a transfer that was defined by a formula clause that limited the value of gifts of LLC interests to individuals and caused a larger share of the property to pass to charity if the transferred property was worth more than was reported on the gift tax return. In *Estate of Christiansen v Commissioner* (8th Cir 2009) 586 F3d 1061, the taxpayer used a similar approach, a formula disclaimer to prevent increases in the value of an estate on audit. In both cases the defined value formula was upheld. Practitioners who want to use this approach would be well-advised to carefully examine the facts in both of these cases and replicate the procedural steps which included separate counsel for different partners.

These suggestions clarify that partnership planning, more than ever, must encompass nontax and business motivations. Practitioners also must be vigilant to watch for future developments in this area, as additional court rulings appear likely.

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A 25+ year executive finance and operations career highlighted by the implementation of innovative ideas with solid metrics increasing value and retaining stakeholder commitment. A problem solver, former Marine officer and a Ph.D. (Finance), Carl has learned loyalty, humility and compassion since his childhood years in Brooklyn through civic service, strong ethics and by helping raise five children.

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