

## THE EFFECTIVE USE OF APPRAISERS IN ESTATE PLANNING AND ESTATE AND GIFT TAX LITIGATION

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The determination of the fair market value of an interest in property which is being transferred, either by gift or at death, is the foundation upon which our federal estate and gift tax system is built. The United States Supreme Court has often held that succession taxes, inheritance taxes and estate taxes are constitutional levies by the federal government only if they are applied in a manner that merely is an excise tax at the transfer of property at death.<sup>1</sup> Therefore, only that property which is *transferred* as a result of a taxpayers death or by gift during the taxpayers life can be subjected to taxation under the federal estate and gift tax system. The tax cannot be a wealth tax or a property tax on the intrinsic value of an asset to the decedent or donor at the time the transfer occurs; rather, it must be a tax on the value of the asset transferred.<sup>2</sup>

In determining the value of any asset that is transferred, the legal rights and interests inherent in that property must first be determined under state law (unless federal law supersedes state law). After that determination is made, the federal tax law takes over to determine how such rights and interests will be taxed.<sup>3</sup> The valuation of property for transfer tax purposes is based upon the A 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.<sup>4</sup> Because of this test, there are two primary components of federal estate and gift tax valuation: (1) understanding the state law rights being transferred from the hypothetical willing seller to the hypothetical willing buyer, and (2) determining the fair market value of those interests. As the expert who applies sound appraisal principles to determine the fair market value of the property interests being transferred, whether by gift or at death, the appraiser serves a key role in the estate planning process.

### **I. Appraisals From Qualified and Respected Appraisers Should Be Obtained at the Appropriate Estate Planning Stage.**

The great majority of IRS challenges in the transfer tax area focus on disputing a taxpayers valuation with respect to hard-to-value assets such as partnership interests or closely held corporations. Assuming a supportable legal framework for an estate planning transaction with a hard-to-value asset, the only way for a taxpayer and the IRS to differ on the amount of the tax owed is for each to claim a different value for the asset transferred. If such a dispute arises and progresses to litigation, the result is determined after a battle of the experts.”

The taxpayer should not rely on an accountant or someone who is not qualified as an

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<sup>1</sup> See, e.g., *Knowlton v. Moore*, 178 U.S. 41 (1900); *New York Trust v. Eisner*, 256 U.S. 345 (1921).

<sup>2</sup> See I.R.C. ' ' 2033, 2035-38, 2040(c), 2044 and 2501.

<sup>3</sup> *United States v. Bess*, 357 U.S. 51 (1958); *Morgan v. Commissioner*, 309 U.S. 78 (1940).

<sup>4</sup> Treas. Reg. ' 20.2031-1(b); Treas. Reg. ' 20.2512-1.

appraiser to value a business interest. The taxpayer generally has the burden of presenting credible evidence with proving the taxpayers valuation position.<sup>5</sup> For valuation disputes in court proceedings arising in connection with examinations commencing after July 22, 1998, the burden of proof in a court proceeding may shift to the IRS in certain cases where the taxpayer presents credible evidence with respect to the valuation issues.<sup>6</sup> However, without a well-reasoned appraisal from a qualified appraiser, the taxpayer virtually has no basis to dispute what might prove to be an unrealistic valuation claim by the IRS. Likewise, the IRS has much less of an obligation to show proof of its valuation position. The appraiser should be reputable, qualified and independent. After all, the appraiser may be the taxpayers expert witness in the event of an audit and any related litigation. If a qualified appraisal has not been obtained before filing the estate or gift tax return, the taxpayer will have to pay for a second appraisal when the valuation dispute arises.

The existence of a well-reasoned appraisal from a qualified appraiser can in some cases prevent a valuation challenge from the IRS. When faced with the taxpayers valuation based on the opinion of a well-respected, independent appraiser, the IRS is essentially forced to hire an equally qualified appraiser who can credibly attack the valuation opinion of the taxpayers appraiser and can produce an opinion of value different enough to generate a tax revenue advantage for the IRS. The IRS is going to allocate resources to pay for appraisals if there is an expectation that allocation will be more than reimbursed. It is difficult for the IRS on a cost/benefit analysis to justify spending the money to challenge a reasonable appraisal from a qualified expert which is based upon widely used valuation techniques. This cost/benefit analysis can and should work to the advantage of taxpayers who utilize well-reasoned appraisals.

Examples of situations involving hard-to-value assets which warrant contemporaneous appraisals include:

- a. For hard-to-value assets contributed to a family partnership or a closely held corporation, an appraisal should be obtained at the time the entity is created. This will help to head off the argument that a gift was made when an entity was created.
- b. When creating an entity with a preferred interest (*e.g.*, a “freeze” partnership), obtain a contemporaneous valuation to determine the appropriate interest rate for the preferred interest.
- c. When making a gift of partnership interest, closely held stock or an undivided interest in real estate, obtain an appraisal at the time of the gift. The appraisal can be filed with the gift tax return to begin the three-year statute of limitation for transfers adequately disclosed on a gift tax return.<sup>7</sup>

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<sup>5</sup> T.C.R. 142(a); *Welch v. Helvering*, 290 U.S. 111, 115 (1933).

<sup>6</sup> I.R.C. ' 7491. For the burden of proof to shift, the taxpayer must satisfy the following conditions: (i) the taxpayer must comply with the substantiation and record keeping requirements of the Internal Revenue Code and the regulations, (ii) the taxpayer must cooperate with reasonable requests by the IRS for witnesses, information, documents, meetings and interviews, (iii) taxpayers other than individuals must have a net worth of less than \$7 million.

<sup>7</sup> I.R.C. ' 6501(c)(9).

## II. The Appraisers Credentials and Credibility.

One of the most important assets an appraiser can possess is credibility. The first job is to determine whether the appraiser is qualified to perform the task at hand. If you are not familiar with the appraisers work, consider obtaining and reviewing copies of other appraisals that the appraiser has prepared. This will help you insure that the appraiser understands proper appraisal techniques and can present his or her opinions and conclusions in a concise, understandable form, and that the appraiser understands how to properly support his or her opinions.

Credentials are also an important factor. Does the appraiser have the appropriate level of experience and credentials to demonstrate his or her expertise in valuing the type of asset? For example, business appraisers have various designations, such as the A.S.A. designation (American Society of Appraisers), a designation thought to be one of the highest designations. Likewise, real estate appraisers with an MAI designation are generally thought to be better credentials than appraisers without such a designation. A designation, however, is not the be all and end all. Important consideration should be given to the appraisers actual experience in valuing the type of asset being valued. For example, an MAI appraiser whose principal expertise is in valuing commercial real estate would not be as credible in valuing a large farm than a state certified appraiser with 20 years experience appraising properties in the county in which the farm being valued is located.

With the proliferation of appraisal firms and the expansion of large accounting firms appraisal groups, it is important to remember that you are hiring the individual appraiser, not the firm. The individual appraiser will ultimately be your expert witness to testify in support of the appraisal opinion, not the firm. When dealing with large appraisal firms or accounting firms who provide appraisal services, insure that you have satisfactorily established who your appraiser will be and who will be assisting the appraiser (if anyone) in the preparation of the appraisal report.

Before engaging the appraiser, it is also important to determine how the appraiser has been received by the courts and if there are any published decision in which the appraiser was either criticized or adopted a methodology which might be inconsistent with issues presented in the fact situation. A legal database search under the appraisers name or the appraisers firm name can often turn up the answers to these questions. Likewise, determine whether the appraiser has published any books or articles which might be used to impeach the appraisers work or, if you have employed more than one appraiser, your other appraisers analysis.

Finally, the role of the appraiser is to determine the fair market value of the property interest being appraised, giving consideration to all relevant facts, and to support that valuation with appropriate data and analysis. Although the appraiser must be confident in his or her methodology and conclusions, the appraiser should not become an advocate for the taxpayer's position. In other words, the appraiser cannot simply adopt the taxpayer's analysis or opinion of value, nor should the appraiser be seen as an advocate. Once the finder of fact believes that the appraiser has become the taxpayers advocate and not an independent expert engaged to apply appropriate appraisal techniques to determine the fair market value of the property interest being valued, the appraiser will lose credibility. Judge Beghe recently stated in *Martin Ice Cream Company v. Commissioner*, 110 T.C.

189 (1998) that Experts are not supposed to be hired guns; they lose their usefulness and credibility to the extent that they become mere advocates for the side that hired them.<sup>8</sup> When credibility is lost, the appraiser's conclusions will no longer be considered helpful to the finder of fact in the valuation dispute, and they will be disregarded.

### III. The Appraiser Must Apply the “Fair Market Value” Standard.

In preparing appraisals for estate and gift tax purposes, many appraisers fail to focus on the correct definition of fair market value. For federal estate and gift tax purposes, fair market value has long been 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”.<sup>9</sup> All relevant facts and elements of value as of the applicable valuation date shall be considered.<sup>10</sup> For purposes of determining the fair market value of property being valued, the identity and intentions of the recipient of the property is irrelevant. The standard is an objective test using hypothetical buyers and sellers in the marketplace, and is not a personalized one which envisions a particular buyer and seller.<sup>11</sup> This point has also been emphasized in the updated edition of *Valuation Training for Appeals Officers* (1998) (issued by the Internal Revenue Service National Office), which stresses the hypothetical willing buyer and seller, and states unequivocally that it is irrelevant who are the real seller and buyer. However, if the interest being valued is a partial interest in property, the identity of the owner of the interests which are not being transferred and the effect of such ownership on the value of the property being transferred is highly relevant.<sup>12</sup>

### IV. Dealing With Legal Issues.

One of the more difficult areas in appraisal work is the question of how to deal with legal issues that are in dispute in the context of a valuation. Examples of such issues include the effectiveness of a buy/sell agreement and the rights of an owner of a partial interest in property. Examples of such partial interests include undivided interests in real estate, limited partnership interests, and ownership of less than all of the shares of a corporation. Each of these ownership interests carries with it a different bundle of rights and obligations under applicable state law.

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<sup>8</sup> *Martin Ice Cream Company v. Commissioner*, 110 T.C. 189 (1998), citing *Estate of Mueller v. Commissioner*, 63 T.C.M. (CCH) 3027 (1992) and *Estate of Halas v. Commissioner*, 94 T.C. 570 (1990).

<sup>9</sup> Treas. Reg. 20.2031-1(b).

<sup>10</sup> *Id.*

<sup>10</sup> *LeFrak v. Commissioner*, 66 T.C.M. (CCH) 1297, 1299 (1993). *See also Estate of Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996) (We are precluded from considering evidence submitted by the government regarding who actually received the assets.©).

<sup>10</sup> *See* Treas. Reg. 20.2031-1(b).

<sup>11</sup> *LeFrak v. Commissioner*, 66 T.C.M. (CCH) 1297, 1299 (1993). *See also Estate of Bonner v. United States*, 84 F.3d 196 (5th Cir. 1996) (AWe are precluded from considering evidence submitted by the government regarding who actually received the assets.©).

<sup>12</sup> *See* Treas. Reg. 20.2031-1(b).

Understanding the rights that a hypothetical seller can transfer, and the rights that a hypothetical buyer can receive, is critical to the valuation analysis. The appraiser's role is to determine the price at which property interest being valued would change hands between a willing buyer and a willing seller, both having reasonable knowledge of relevant facts. Relevant facts include all of the attributes attached to the property being transferred, including any legal rights or obligations attached to the property. For example, is the hypothetical buyer of a partnership interest automatically entitled to become a partner, or is the buyer limited to the status of a mere assignee (with no management rights, limited or no information rights and no right of withdrawal).

Most appraisers, however, are unqualified to render a legal opinion, and should not try to do so. Where complex questions of law exist, the appraiser should rely on the opinion of qualified counsel as to the likely understanding of the rights and privileges attached with the interest being valued. For example, if a buy/sell agreement exists for a closely held entity and its application is uncertain, the appraiser generally should not opine on whether the buy/sell agreement is valid. A knowledgeable owner of the interest being valued -- whether a buyer or seller -- would likely consult with an attorney to analyze his or her rights in connection with the enforceability of such a buy/sell agreement, since the legal issue may have a significant impact on the value of the property interest. See, e.g., *Estate of Newhouse v. Commissioner*, 94 T.C. 193, 231 (1990) (A hypothetical willing buyer would have had the counsel of several advisors of formidable reputation). It is not necessary to obtain a conclusive determination of the legal issue but, as the Tax Court stated in *Newhouse*, it is a likely understanding of the rights and privileges . . . that will influence the terms of the sale, not whether we resolve this dispute over New York law.

## **V. Whether And When To Use A Team of Experts.**

In valuing an asset or a closely held business, the need for more than one expert often arises. The valuation of an undivided interest might include an analysis of local law regarding the rights of an undivided interest owner, an appraiser who can analyze both the 100% value of the property and the sales of comparable undivided interests. If the property is income producing, a business appraiser might analyze the value on a "going concern basis". If environmental problems exist, an environmental engineer might be consulted to determine the cost of remediation or the effect of the problem on the property's fair market value. For a closely held business, experts such as business appraisers or investment bankers will be useful. If the business itself contains hard-to-value assets which require special expertise, those assets can be separately appraised by specialists.

## **VI. The Estate Planning Professional Should Hire the Appraiser.**

Working with appraisers is an everyday event for most estate planning professionals. On the other hand, working with appraisers can be something of a rarity for most clients, many of whom have dealt with appraisers only in the purchase of their home. In addition, many clients do not enjoy working with appraisers. Although they are necessary, they are also expensive and slow down transactions.

In most cases, the planning lawyer, not the client, should hire the appraiser for an estate planning transaction. The estate planning lawyer can offer guidance both to the client and the appraiser as to how similar transactions have been handled in the past by the IRS and the courts. It

will also provide the taxpayer with an argument that any unused reports or correspondence is attorney work product.

## **VII. Remember That Anything Committed to Writing May Be Discoverable.**

Any document in the appraisers file is subject to being discovered during the audit process or in subsequent valuation litigation.<sup>1</sup> This includes written correspondence, e-mails, notes and drafts of appraisals. Experienced appraisers should know this; however, it never hurts to remind them. Once again, the attorney, the appraiser and the client should focus on who the audience may ultimately be and understand that the appraisers file may be reviewed by the examining agent, appeals officer, district counsel or the ultimate finder of fact in estate or gift tax litigation.

As a general rule, there is no benefit for the estate planner, the client or the appraiser to keep drafts of an appraisal once the finished product has been completed. The appraisal and the appraisers work papers should contain all relevant information that is necessary to support the valuation. Drafts of appraisals may not be subject to the attorney-client privilege or the attorney work product privilege. Once the appraiser is designated as an expert in litigation, any privilege which existed is lost. A document request from an examining agent or district counsel may include a request for all drafts of any appraisals. Drafts which differ significantly from the finished product can be used to impeach the appraisers results. The appraiser, on examination, will need to explain the reason for the difference between the draft and the final product.

## **VIII. The Appraisal Should Be in a Form Which Fully Sets Forth the Appraisers Conclusions and Is Admissible in Court.**

Even when an appraisal will only initially be used to establish the fair market values of an asset in connection with the filing of an estate or gift tax return, the appraisal report should be in a form which will allow the report to be introduced in subsequent tax litigation. Preparation of the report with this potential end use in mind is not difficult and will avoid the need to have the appraiser prepare a new or revised report in the event the matter proceeds to trial. Rule 143(f) of the United States Tax Court sets forth the requirements for the experts report, and provides:

The report shall set forth the qualifications of the expert witness and shall state the witness opinion and the facts or data on which that opinion is based. The report shall set forth in detail the reasons for the conclusion, and it will be marked as an exhibit, identified by the witness, and received in evidence as the direct testimony of the expert witness, unless the Court determines that the witness is not qualified as an expert. Additional direct testimony with respect to the report may be allowed to clarify or emphasize matters in the report, to cover matters arising after the preparation of the report, or otherwise at the discretion of the Court. Expert witness testimony will be excluded altogether for failure to comply with the provisions of this paragraph, unless the failure is shown to be due to good cause and unless the failure does not unduly prejudice the opposing party, such as by significantly impairing the opposing party's ability to cross-examine the expert witness or by denying the opposing party the reasonable opportunity to obtain evidence in rebuttal to the expert witness

testimony.<sup>13</sup>

In most Tax Court cases, the appraisal report will serve as the experts direct testimony. Unless permitted by the Court, no oral direct testimony from the appraiser will be admitted regarding the appraiser's valuation. It is, therefore, imperative that the appraisal contains all facts, data and reasoning on which the appraiser bases the valuation conclusion. The methodology must be rational and understandable. If a part of the appraisal is based upon third-party contacts, those contacts should be identified. If a part of the appraisal is based upon comparable sales or statistical data, the sales and statistical data should be identified and included in the report. While the inclusion of this material may make the report more cumbersome, it will allow the reader to fully understand all of the reasons for the appraiser's valuation conclusion. Put yourself in the position of the uninformed reader of the report who is attempting to use the appraisal to determine the fair market value of property--does the appraisal contain all of the information in a clear, rational and logical manner to allow the reader to fully understand and decide for himself whether the appraisers conclusions are correct?

#### **IX. When Valuing Partial Interests, Valuation Experts Generally Conclude That Significant Discounts are Appropriate Because the Transferred Interest Lacks Liquidation Control and Is Not Marketable.**

Most ownership interests in family limited partnerships or other closely held entities are worth less than liquidation value when valued by the income approach or net asset value approach. The primary reasons are that most of the cash flow generated within the entity is reinvested instead of being distributed to the equity owners and a buyer generally does not obtain liquidation control. A buyer who obtains liquidation control would pay a higher price for access to the retained cash than a buyer who does not acquire liquidation control would pay for the low distributable yield.

Case law supports a potentially substantial difference between liquidation value and the value obtained by the income approach or net asset value approach. The valuation of an ownership interest in a business entity for tax purposes generally is determined by reference to the price a hypothetical willing buyer would pay a hypothetical willing seller. Assuming that neither is under a compulsion to enter into the transaction and that both are fully apprised of all relevant facts. Situations where a taxpayer does not have unilateral liquidation control of a family partnership, depending on the partnerships distributable cash flow, courts have found that the taxpayers interest in the partnership may have a value as much as 40% to 85% lower than if a hypothetical willing buyer had liquidation control. For a more complete analysis of the valuation factors relevant for partnership interests. *See IRS Valuation Guide for Income, Estate and Gift Taxes - Valuation Training for Appeals Officers*, pp. 9-1 to 9-51 (CCH Federal Estate and Gift Tax Reports, Number 239, January 28, 1994).

The income approach to valuation generally entails the capitalization of current earnings or the discounting of future earnings. In either case, the valuation expert selects the appropriate measure of earnings power (net income, gross cash flow, net cash flow, operating cash flow, or some other measure) to capitalize or to discount to present value. Generally, a capitalization of earnings method is used when there is no expected growth in earnings or the expected growth is consistent. A discounted cash flow method is used when future growth is predictable and varies significantly over

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<sup>13</sup> T.C.R. 143(f).

the predicting period.

The net asset value approach generally is used for valuing partnerships which own financial securities or passive investments in oil, gas, timber or real estate. Under this approach, the valuation expert computes the fair market value of the assets owned by the partnership entity and subtracts the value of the partnerships liabilities, after which he or she applies two discounts: (i) a minority interest discount or lack of liquidation control discount and (ii) a marketability discount.

The magnitude of the minority interest discount depends on the level of distributions from the partnership to the partners, the financial risk associated with the partnership's assets, and the terms of the partnership agreement. Because control premiums have been studied in the corporate takeover context, the inverse relationship of a minority interest discount to a control premium gives experts an accurate base from which to determine a minority interest discount. A minority interest discount for an assignees rights attributable to a partnership interest typically is in the range of 20% to 40%.

The magnitude of the marketability discount is determined by reference to sales of restricted stock of publicly traded companies. Because of several independent studies, experts confirm a range of restricted stock discounts from 30% to 45%. Another source of reference for experts is the comparison of the sale of a minority block of stock in a closely held corporation to the value of the same block of stock after the corporation goes public. Such studies have revealed discounts ranging from 42% to 74%.

Substantial discounts are appropriate even if the only assets of the investment company, partnership or corporation are passive investments such as undeveloped real estate, stocks, bonds, and cash. In general, valuation experts and courts allow for a (lesser) minority interest discount in the range of 10% to 20% (similar to closed end investment funds) while still allowing for the normal range of marketability discounts. *See Estate of Luton v. Commissioner*, 68 T.C.M. (CCH) 1044 (1994) (decendent owned 78% of a passive real estate corporation, yet the court still allowed a 20% marketability discount; the decendent also owned 33% of the stock of a corporation that owned a duck hunting preserve, and the court allowed a combined 35% minority interest and marketability discount; the court also understandably allowed only a 10% marketability discount for an interest in an I.R.C. '337 liquidating trust which was required to distribute the proceeds of its only asset, a note paying 10% from a credit worth corporation, 30 days after receiving the cash proceeds); *Estate of Simpson v. Commissioner*, 67 T.C.M. (CCH) 2938 (1994) (decendent owned 100% of an investment holding corporation and the court allowed a 30% marketability discount); *Dougherty v. Commissioner*, 59 T.C.M. (CCH) 772 (1990) (decendent owned 100% of the stock of a personal holding corporation with assets consisting of notes receivable, marketable securities, and passive real estate partnership interests, and the court allowed a 35% marketability discount); *Estate of Gillet v. Commissioner*, 50 T.C.M. (CCH) 636 (1985) (decendent owned 26.4% of the stock of a corporation with assets consisting largely of passive investments, yet the court allowed a 20% minority interest discount and a 15% marketability discount); *Estate of Mundy v. Commissioner*, 35 T.C.M. (CCH) 1778 (1976) (all of the assets of the personal holding corporation were stocks, bonds, and treasury securities, yet the court allowed a combined 40% minority interest and marketability discount); *Estate of Thalhermer v. Commissioner*, 33 T.C.M. (CCH) 877 (1974) (decendent owned 8.29% of a corporations Class A voting stock and 5.31% of its Class B non-voting stock, and the corporation owned substantial common stock investments, yet the court allowed a combined 34% discount for the voting stock and a

37% discount for the non-voting stock).

There are a number of studies and an increasing amount of data which support the theoretical discounts to liquidation value. Three of the more complete and better known of these studies are those performed in 1992, 1993, and 1994 by Partnership Profiles. Partnership Profiles, Inc., "LP Secondary Market Discounts: How Much?," *The Perspective* (May/June 1992): 1-2; and Partnership Profiles, Inc., "LP Secondary Market Discounts: An Update?," *The Perspective* (May/June 1993): 1-4; and Partnership Profiles, Inc., "The Low-Down on Secondary Market Discounts," *The Perspective* (May/June 1994). In those studies, the actual trading prices of investment units on the secondary market were compared to valuations of those units by the general partners or independent appraisers. The 1992 studies found that secondary market discounting averaged 44%, the 1993 studies concluded that this figure increased to 46%, and the 1994 studies concluded that this figure increased to 48%. Another study which was commissioned by the Investment Program Association in 1992 found an average discount from estimated values of 48%. Mark S. Thompson, Ph.D. and Eggert Dagbjartsson, "Market Discounting of Partial Ownership Interests," *The Appraisal Journal* (October 1994).

The studies mentioned above involved publicly offered partnerships that were not publicly traded. Clearly the discounts would be greater for the typical family limited partnership because there does not exist any secondary market and because the cash distributions are extremely low. According to a recent article in *The Appraisal Journal*, in a no cash flow or low cash flow situation, a careful analysis of the 1992 and 1993 studies by *Partnership Profiles* would indicate that discounts are as high as 70% to 90%:

An important finding of the 1992 and 1993 studies by Partnership Profiles is the importance of cash distributions to investors in the pricing of these investment units; that is, the greater the annual cash flow to the holders of the units as a percentage of net asset value, the less the discount applied in the marketplace. For partnerships with no cash flow, discounts have averaged nearly 70% and have, at times, risen to as high as 90%. For some partnerships, no buyers could be found at any price -- suggesting that the discount was 100%. These latter partnerships were excluded from the 1993 study. Mark S. Thompson, Ph.D. and Eggert Dagbjartsson, "Market Discounting of Partial Ownership Interests," *The Appraisal Journal* (October 1994).

In connection with his presentation to the AICPA business valuation practitioners on November 16, 1998, Charlie Elliott of Howard Frazier Barker Elliott, Inc. in Houston shared the following information regarding the discounts from net asset values (ANAV@) recently observed in various public markets which his firm uses for reference points in arriving at discount factors to apply to securities and real estate partnerships. As Mr. Elliott states, "The investment company discount and the secondary market discount (derived from the secondary market for limited partnership interests) are basically proxies for the minority interest discount which is appropriate to apply to assignee/non-controlling/non-marketable, limited partnership interests, matching the appropriate asset categories represented in a partnership's asset mix."

What follows is an excerpt from Mr. Elliott's outline:

1. Asset Categories

a. Securities

- (1) Draw analogies with closed-end investment companies (stock and bond closed-end funds, both corporate and municipal).
- (2) At August 7, 1998, the range of discounts/premiums applied to the net asset values (“NAVs”) among representative groups of closed-end funds was as follows:

- (a) Stock funds [range B a 21.6 percent discount to a 5.8 percent premium. The middle 50 percent of the ranked range of discounts/premiums (the 75<sup>th</sup> through the 25<sup>th</sup> percentile) was a 16.2 percent discount to an 8.2 percent discount]. Discount figures are parenthesized below.

75 <sup>th</sup> percentile	(16.2)%
Median	(9.5)
25 <sup>th</sup> percentile	(8.2)

- (b) Corporate bond funds (range - 12.1 percent discount to a 2.6 percent premium)

75 <sup>th</sup> percentile	(4.3)%
Median	(3.2)
25 <sup>th</sup> percentile	(0.2)

- (c) Municipal bond funds (range - 13.8 percent discount to a 7.3 percent premium)

75 <sup>th</sup> percentile	(4.5)%
Median	(3.3)
25 <sup>th</sup> percentile	0.7 premium

- (d) Government bonds (range B a 13.2 percent discount to a 1.8 percent discount; median 5.8 percent discount).

b. Limited partnership interests

- (1) The Partnership Spectrum, published bi-monthly by Partnership Profiles, Inc., is an important source of fundamental and valuation information regarding limited partnership interests trading in the secondary market for limited partnership interests. The analogy to privately-owned partnership interests is directly akin to the analogies drawn by valuation experts between publicly-traded securities and similar securities of closely-held corporations.
- (2) Below are enumerated various valuation benchmarks derived from information

compiled from recent issues of The Partnership Spectrum for a large number of partnerships whose units trade in the secondary market.

(a) Overview as provided in the May/June 1998 issue of The Partnership Spectrum.

	<u># of Partnership</u>	<u>Average Discount</u>	<u>Average Yield</u>
Equity partnerships			
Distributing			
Low or no debt	33	27%	8.0%
Moderate to high debt	29	36%	6.7%
Non-distributing	21	43%	0.0%
Triple-net-lease (all distributing)	20	17%	9.7%
Insured mortgage programs (all distributing)	10	12%	9.8%

(b) Equity real estate partnerships which are making distributions to their partners.

Discounts from NAV

75 <sup>th</sup> percentile	(37.6)%
Median	(33.0)
25 <sup>th</sup> percentile	(23.2)

Price to cash flow

75 <sup>th</sup> percentile	11.3x
Median	9.4
25 <sup>th</sup> percentile	7.0

Yield

75 <sup>th</sup> percentile	9.0%
Median	6.5
25 <sup>th</sup> percentile	4.0

Percentage of cash flow distributed

75 <sup>th</sup> percentile	90.4%
Median	65.0
25 <sup>th</sup> percentile	36.8

Leverage

75 <sup>th</sup> percentile	48.0%
Median	33.0
25 <sup>th</sup> percentile	0.0

- (c) Equity real estate partnerships which are not making distributions to their partners.

Discounts from NAV

75 <sup>th</sup> percentile	(51.4)%
Median	(42.0)
25 <sup>th</sup> percentile	(35.9)

Price to cash flow

75 <sup>th</sup> percentile	9.7x
Median	7.4
25 <sup>th</sup> percentile	6.4

Leverage

75 <sup>th</sup> percentile	68%
Median	54
25 <sup>th</sup> percentile	49

Another article (Kern, Schroeder and Smith “The Market Pricing of Syndicated LPS and the Valuation of FLPs,” *Trust and Estates Journal*, p. 35 (February 1996)) analyzing the Partnership Profiles data notes that family partnerships should be much less valuable than the syndicated partnerships that are part of the study in the Partnership Profiles data and concludes as follows:

The first fundamental difference between syndicated partnerships and FLPs involves the experience of the general partner in operating and administering such a business entity. FLPs generally do not designate professional managers as the general partner, but rather the current owner of the assets who is forming the FLP. Therefore, the management risks are more pronounced for the FLP and consequently greater for the limited partners of the FLP than for their syndicated partnership counterparts.

The second significant fundamental difference is an asset risk. Syndicated partnerships usually hold many assets, with a broad geographic diversification. This numerical and geographic diversity of assets, even of a single type, provides some spreading of risk of the partnership compared to one with few assets and limited geographic dispersion. The reduced portfolio risk of the syndicated partnership is typically not enjoyed by the interests of the FLP which are usually structured with one significant asset such as an apartment house, shopping center or building and several lesser properties. The extremes in geographic and market risks found in an FLP typically are absent in the syndicated partnerships.

The third significant fundamental difference is the distribution of cash prior to the partnership's liquidation. An investor in a syndicated partnership usually has an expectation for current income of cash distributions based on some formula relative to the partnership's operations satisfying certain criteria or financial hurdles, as provided in the limited partnership agreement. Income derived from the operating surplus or gains from the sale of assets are sources of cash that provide the limited partner with an economic benefit which the secondary market can use as a basis for pricing the security. In contrast, an investor in an FLP is aware that current income, if any, could well be (and typically is) only enough to cover their portion of the tax liability allocable from the partnership's taxable income. The general partner of the FLP in all likelihood has less motivation or requirement to sell assets and generate a return of capital to a third party investor than does the general partner of a syndicated partnership. Therefore, the expected return on an investment in an FLP is even more remote than it is for a syndicated partnership.

The fourth significant difference is the relative lack of any organized secondary market for FLP interests. The conventional measures used in pricing LPS severely punish those that do not provide a track record for distributing cash from current income or return of capital. If the FLP was tradable, investors could expect to get hammered for the absence of these economic benefits. Removing the most obvious vehicle for liquidity from a security with relatively undesirable investment attributes is virtually unforgivable because the holding period for this economic bust would be perceived as indefinite. A third party buyer of an interest in the FLP would invest because he expects an unusually large gain on the sale of the partnership's asset(s), and is prepared to wait perhaps indefinitely for this blessed event to occur.

Separately, we have initiated a study of private partnerships that have traded in the secondary market. We have observed that discounts for private LPS are substantially larger than discounts required for the syndicated partnerships. Investors in private LPS demand current returns on their investments in the range of 20 percent for a typical non-syndicated partnership interest as compared to 10-14 percent for the syndicated LPS. This is because of 1) lack of competitive bidders for these partnerships resulting in an attendant greater illiquidity in comparison to the syndicated LPS, 2) non-mandated distributions, 3) the lack of professional management, 4) a greater disregard for the limited partners by the general partners, 5) a limited partnership agreement which is often prejudiced in favor of the general partners, and 6) the assets in the partnership are typically either of one class or only one property, thereby depriving potential investors of any diversification or risk avoidance possibilities. The results of this study of private partnerships will be available shortly.

In an outline prepared by Business Valuation Services, Inc. for the Continuing Professional Education for the IRS Federal Estate and Gift Tax Attorneys of the Midstates Region (“Valuation: Common Battleground Issues and Anecdotal War Stories,” Business Valuation Services, Inc. (August 15, 1995)) the following observations were made:

Family Limited Partnership Discounts: Studies are rare, and reliable data is limited. Data is available by talking to experienced brokers of such interests. Some published articles discuss typical discounts observed by brokers. Theoretical calculations, using published required return differentials, can be used to supplement and test the observed discounts. Discounts can be very large for non-income producing investments with substantial risk to the underlying basis of the investments over time and with little prospect for liquidity in the near future. Discounts can be relatively small or modest if the investments produce healthy income streams to shareholders and have little risk of losing value over time. Discounts are almost always calculated off of net asset value as determined by valuing the underlying investments at their control values.

Recently, we requested that the IRS admit through requests for admissions that certain factors the IRS utilized in a partnership valuation case, (*Robertson v. Commissioner*, Tax Court Docket Nos. 26090-95, 26091-95, and 12782-96) were appropriate for determining the amount of a discount in determining the value of a limited partnership interest in another tax court valuation case. *Estate of Brown v. Commissioner* (Tax Court Docket Nos. 7492-95 and 14899-96). In the *Robertson* case, the IRS used a 70% discount in valuing a limited partnership interest which was purchased by the parents from one of their children. The primary asset of the partnership was non-income producing ranch land. In response to informal discovery, with respect to the valuation of the limited partnership interest in *Robertson*, a letter dated August 15, 1996 from the District Counsel of the IRS Midstates Region stated that:

Respondent admits that a discount of 70% was used in valuing the 6% limited partnership interest. Respondent believes that there are many considerations that enter into evaluation of a partnership interest. Those consideration (sic) include lack of lack of (sic) marketability and minority interest. Respondent also believes that in valuing interest in family limited partnerships, such as the 6% interest in [Robertson family partnership], considerations must be given to other additional factors, including, but not limited to: management risk, asset risk that arise due to concentration of asset in one class/or geographic region, limited cash distributions to partners, limited liquid assets for making distributions, expected returns, lack of an active organized secondary market for interest, restrictions on the transfer of interest by partners, concentration of control over the partnership, the economic outlook for the business or geographic area the partnership operates in, the partnership’s position in the industry, the partnership’s historical profitability, and expectation of future profitability, values of comparable interest traded on secondary markets and restrictions on transferability.

In *Brown*, we requested that the Service admit that the considerations set forth above were proper factors for an appraiser to consider in determining the fair market value of the partnership interests owned by Mrs. Brown at the time of her death. The Service responded to our request as follows:

Admits, but denies any application that such a listing encompasses the universe of appropriate factors to consider.

## **X Valuing Partial Interests, Discounts Must be Appropriately Tied to the Specific Attributes of the Interest in the Entity Being Appraised.**

In determining the fair market value of a partial interest in a closely held business, appraisers often rely on various studies to determine the discounts for lack of control and lack of marketability. These studies which help the appraiser quantify and select the appropriate minority interest discount include (1) studies of tender offers (control price premiums), and (2) studies of closed-end investment funds. Studies which help the appraiser quantify and select the appropriate discount for lack of marketability include: (1) studies of restricted (letter) stock transactions, and (2) studies of private transactions prior to initial public offerings. Unfortunately, many appraisers blindly apply the results of these studies without actually comparing the attributes of the stock reflected in the studies to the interest being valued. All too often an appraiser will simply average the results of the studies and apply the resulting discount to the percentage value of the interest being valued. A report which takes that approach may strike the IRS and the Court as a useless “cookie-cutter” approach.

Simply relying on these commonly used valuation studies without tying those studies to the specific attributes of the entity being appraised is not sufficient. It is practically impossible to prescribe a single standard or formula which must be applied in arriving at fair market value in each case. The appraiser should carefully consider all relevant factors regarding the entity, and the weight to be accorded each factor will be different depending upon the facts, circumstances and perspective of the case at hand. For example, in *Mandelbaum v. Commissioner*, 69 T.C.M. (CCH) 2852, 2864 (1995), Judge Laro provided a list of ten nonexclusive factors which should be considered when valuing unlisted stock. Judge Laro stated:

Ascertaining the appropriate discount for limited marketability is a factual determination. Critical to this determination is an appreciation of the fundamental elements of value that are used by an investor in making his or her investment decision. A non-exclusive list of these factors includes: (1) The value of the subject corporation’s privately traded securities vis-a-vis its publicly traded securities (or, if the subject corporation does not have stock that is traded both publicly and privately, the cost of a similar corporation’s public and private stock); (2) an analysis of the subject corporation’s financial statements; (3) the corporation’s dividend paying capacity, its history of paying dividends, and the amount of its prior dividends; (4) the nature of the corporation, its history, its position in the industry, and its economic outlook; (5) the corporation’s management; (6) the degree of control transferred with the block of stock and the value; (7) any restrictions on the transferability of the corporation’s stock; (8) the period of time for which an investor must hold the subject stock to realize a sufficient profit; (9) the corporation’s redemption policy; and (10) the cost of effectuating a public offering of the stock to be valued, e.g., legal, accounting and underwriting fees.

Judge Laro then examined each of these factors to determine whether the factor favors an above-average or below-average marketability discount. While those criteria may not fit each

valuation situation, the criteria demonstrates that the Tax Court desires more than simple blind reliance on the “average” result of valuation studies. Careful thought should be given by the appraiser to how the interest being valued compares to the companies analyzed in each study relied upon.

## **XI. The New “Discount” the Built-in Capital Gains Tax Deduction**

The recently decided Davis case, for the first time since the repeal of General Utilities, documented a position for the recognition of the real liability represented by the built-in capital gains tax associated with appreciated capital assets held in a C corporation. In Technical Advice Memorandum 9150001, the IRS concluded, based on prior tax court decisions, that the repeal of General Utilities by the Tax Reform Act of 1986 (General Utilities and Operating Company v. Helvering, 296 U.S. 200 (1935) had no material effect on the transfer tax value of the stock of a C corporation holding appreciated assets where liquidation of the underlying assets was speculative. Taxpayers and the business valuation community strongly disagreed with this position.

Following quickly on the heels of this decision was the August 18, 1998 decision of the United States Court of Appeals for the Second Circuit reversing Eisenberg. The Appeals Court found that the Tax Court erred in not considering the built-in capital gains tax as a liability and remanded the case back to the Tax Court to decide on the amount of the liability. This reversal is the last nail in the coffin of the notion that built-in capital gains taxes should not be considered in valuing C corporations.

The issue of the applicability of the capital gains tax as a liability and the amount of the liability is intertwined with several issues, including (1) the availability of viable exemptions or options by which the tax may be avoided and (2) the valuation approach used in calculating value.

These issues and, perhaps, others will determine how much of the built-in capital gains tax should be deducted. This is a complicated, fact-driven determination and there is no technique which is uniformly applicable for all situations. After all, the appraiser's role is to estimate value based on what occurs in that complex and vague organism known as the "marketplace". The marketplace itself is different for each type of transaction. In one instance one might be referring to the real estate finance market, in another, the leveraged buy-out sector, and, in another, the market for restricted stock. This is precisely why the IRS' simplistic attempt to deal with this issue with one succinct private letter ruling was doomed from the start.

## **XII. Expert Disasters**

Credential Inflation - The natural tendency of every expert is to look as impressive as possible. Unfortunately, this leads to the temptation of embellishing resumes and experience beyond the bounds of accurate reporting. This can and has lead to disastrous consequences on the stand when the opposition, after doing their homework, discovers and exploits any false claims thereby undermining the credibility of the witness. If you do not know your expert, make him provide evidence of any special claims to expertise besides normal credentials and education.

Prior Testimony or Articles - An expert is not necessarily bound forever to any statement

made in a prior case or publication. However, if what he or she intends to say in your case is in conflict with prior testimony, you must be aware of it and there must be a reasonable explanation. The reasons are obvious. But the search for conflicting testimony does not end with an individual, in this day of large valuation firms, including the major accounting firms, you must also search out prior testimony or articles by anyone in that firm.

The Uninformed Testifier - Some firms will staff a project in the following manner: the “number crunching” is done by young analysts (frequently just out of school); due diligence and report writing is done by middle level professionals; a more senior project manager will review, edit reports and participate in some of the due diligence. Finally, the partner or other “top level” professional will review the report and, after being satisfied, will sign it. This many layers of involvement can be dangerous when the time comes for testimony. If the testifier did not attend meetings, due diligence sessions and is generally uninformed about the client’s business, he or she may make a poor witness, regardless of impressive credentials.

Pseudo-Scientific Methodology - Revenue Ruling 59-60, the guideline for all tax-oriented business appraisal, states that “valuation is a prophesy as to the future”. It also speaks to the need for informed judgment based on experience and reason. The subject of finance is by its nature highly quantitative. College courses in the subject involve large degrees of mathematical and statistical methods. However, what is taught in the classroom on such topics as arbitrage pricing theory and multi-regression analysis is not very useful as a primary methodology on which to base an opinion if the appraiser can not explain it to the judge and if there is no indication that this methodology is widely used by “real” investors in the marketplace. The appraisers job, after all, is to replicate the investment behavior of hypothetical buyers and sellers, not to invent new financial theories

Friendly Fire - When using more than one expert, make sure that both experts have read and discussed each other’s reports after they have been filed. The experts should be kept apart while they are formulating their opinions so that the opposition can not claim collusion. But, after the reports are filed, they should be aware of each other’s work. Failure to do so can allow your opposition to attempt to cause one expert to unintentionally impeach another one. For example, serious damage can be done by one expert simply agreeing to a leading and seemingly unimportant (from the vantage point of that expert) question which he has not really had time to consider.

<sup>1</sup> For the purpose of ascertaining the correctness of any return, making a return where none has been made, or determining the liability of any person for any internal revenue taxes the IRS is authorized (i) to examine any books, papers, records, or other data which may be relevant or material to such inquiry, and (ii) to summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the IRS may deem proper to produce such books, papers, records or other data. I.R.C. ' 7602(a).