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Forensic & Valuation Services

Practice Aid

Business Valuations for Estate and Gift Tax Purposes

Notice to Readers

Acknowledgments

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Joe Emanuele, Chair	Richard Claywell
Rosanne Aumiller	Russell Glazer
Stephen Bravo	James Lurie
Frank "Chip" Brown	Peter Thacker
Brenda Clarke	Linda Trugman

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AICPA Staff

Jeannette Koger *Vice President* *Member Specialization & Credentialing*	Eva Simpson *Technical Manager* *Forensic and Valuation Services Section*
Eddy Parker *Assistant Director* *Forensic and Valuation Services Section*	Mark O. Smith *Technical Manager* *Forensic and Valuation Services Section*

Chapter 1

Scope

The intent of this practice aid is to highlight best practices for valuations performed for estate and gift tax purposes. This practice aid does not provide in-depth discussions of business valuation methodologies. For that level of detail, there are a plethora of books, practices aids, and online courses available that explore the intricacies of business valuation. The Forensic and Valuation Services (FVS) section of the AICPA website can be a valuable resource for more in-depth learning materials. Instead, this practice aid will address the broader issues and topics related to business valuation specifically from the perspective of a CPA who performs the valuation of a business, business ownership interest, security, or intangible asset (herein after referred to as *valuation analyst*) for estate tax or gift tax purposes.

Estate and Gift Tax Overview

The impact of estate and gift taxes on estate planning strategies must be constantly monitored and evaluated as both the estate tax rates and exemption amounts change from year to year. For example, the top federal estate tax rate has declined to 40 percent from 48 percent over the last 10 years (2004–2014). In conjunction with the decline in the estate tax rates, the federal estate exemption amount has increased to $5.34 million from $1.5 million for the same period. Fluctuations of this magnitude can have significant, and possibly unintended, consequences on an estate plan especially if it is not drafted to account for changes to tax and exemption amounts from year to year. Given the dynamic nature of the estate and gift tax rules and regulations, estate planning professionals, including valuation analysts, must do their part to stay fully informed about how current and future changes in this area can and could impact the professional guidance given to clients. [fn 1]

The estate tax, sometimes referred to as a "death tax", and the gift tax must be considered together when developing any estate planning strategy. Understanding the differences between the two taxes, however, is important to maximize wealth transfer to the intended beneficiaries.

The estate tax is an excise tax paid by the decedent's estate on the fair market value of the net assets included in the decedent's estate on the date of death. [fn 2] In order to assess what assets and liabilities make up the gross estate, the estate's executor will conduct an accounting (that is, inventory), which is generally performed with the assistance of legal and financial professionals. Once the executor and probate court have agreed that all estate assets and liabilities are accounted for, the assets and liabilities are assigned a fair market value that will, in turn, be reported on the IRS Form 706 (Form 706). The total fair value of all of the estate's assets is the *gross estate*. The includible property may consist of cash, securities, real estate, insurance, trusts, annuities, business interests, art, jewelry, and other assets. The total fair value of all of the estate's liabilities is the *total allowable deductions*. Allowable deductions may

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[fn 1] *N.B.*, In addition to federal estate taxes, several states impose taxes that are considered "estate taxes" or "inheritance taxes" which must be considered as part of the estate planning process.

[fn 2] The fair market value of the estate may be determined on an alternative valuation date. See chapter 3 IRC Section 2032.

include funeral expenses, debts of the decedent, mortgages and liens, administrative expenses, bequests or transfers (or both) to a surviving spouse, and other deductions. The gross estate is reduced by the allowable deductions to arrive at the *tentative taxable estate*. At this point, adjustments are made to the tentative taxable estate to take into account state death taxes paid and transfers made during the decedent's life which exceeded the annual exclusion limits in effect on the date of the gift (reported on IRS Form 709 [Form 709]). The resultant balance is used to calculate the tentative tax. Any gift taxes paid by the decedent are subtracted from the tentative tax to arrive at the gross estate tax which is further adjusted by a multitude of exclusions and credits to determine total transfer taxes due.

The gift tax is a tax paid by the donor on the transfer of property by one individual to another while receiving nothing, or less than full value, in return. [fn 3] A gift is deemed taxable only when the amount transferred to one individual exceeds the annual exclusion amount. The amount is automatically adjusted for inflation. There is no limit to the number of individuals a taxpayer can gift to and the transfer can be in the form of a single transaction or multiple transactions throughout the year. Of course, there are methods by which the taxpayer can reduce or eliminate the gift tax filing requirement (for example, splitting a gift with a spouse, staggering the gifts into different tax years, and so on), and there are gifts that are exempt from the annual exclusion limit (for example, tuition, medical costs paid directly to provider, gifts to a spouse, and so on). However, when gifts exceed the annual exclusion, the taxpayer must file Form 709 for the year the gift is made. As previously noted, all gifts reported on Form 709 and, technically, all gifts exceeding the annual exclusion amount not reported on Form 709, get reported on the decedent's estate tax return to determine the gross taxable estate.

The estate and gift tax filing requirements can be complex and may require additional legal and tax professionals with extensive training and experience in this area. Valuation analysts can be an integral part in completing these documents; however, whether they have sufficient experience and training to complete and file these documents must be evaluated on a case-by-case basis.

[fn 3] The courts have held that in order for a gift to qualify as a present interest, it must confer a present economic benefit by the use, possession, or enjoyment of the property or for the use, possession, or enjoyment of income from the property. In order for CPAs and valuation analysts to properly structure and execute wealth transfer as an estate planning tool, they need to be cognizant of the criteria of present interest. This is particularly important when incorporating more complex estate planning concepts, such as family limited partnerships and family limited liability companies (discussed in more detail in the sections that follow).

Chapter 2

The Valuation Engagement

A valuation analyst is a natural choice for providing valuation services for gift and estate tax purposes. Most valuation analysts who have experience in this area of tax planning and consulting understand the complexities involved with the ever-changing federal and state tax laws and how to best leverage those rules to help taxpayers minimize their potential estate and gift tax liabilities.

Planning the Engagement

Under AICPA's "General Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.300.001 and 2.300.001),[fn 1] CPAs must undertake only those services that can be completed with professional competence, exercise due professional care in the performance of professional services, plan and supervise the performance of professional services, and obtain sufficient relevant data in support of their conclusions. In order to adhere to the General Standards Rule, the valuation analyst must plan each engagement thoroughly and understand that the planning process will continuously evolve as each phase of the engagement is initiated. The following common areas should be considered when planning an estate and gift valuation engagement.

Assessing the Risk of the Assignment—A critical first step every valuation analyst must take prior to accepting a valuation engagement is to identify the potential risks of an engagement. The valuation analyst should understand both the quantitative and qualitative risks of an engagement before agreeing to perform valuation services.

Quantitative risks are usually risks that can be linked to a specific unit of measure (for example, dollars and percent). For instance, if a company uses historical performance results to estimate future results, there will be a measurable variance between the forecasted results and actual results. The variance is generally considered a quantitative risk because it is the difference between what was planned for and what actually occurred. This variance can be minimized with careful analysis of historical results and thorough assessment of micro and macro influences on the company. Of course, unforeseen events will always be part of the valuation landscape, and so if appropriate, the valuation analyst adjusts for this as needed.

Qualitative risks are usually considered non-numeric in nature. They are generally part of the preliminary risk assessment and are described with subjective intervals (low, medium, high). For example, the valuation analyst may determine that the management of a company is not sufficiently qualified to execute a growth strategy used in their projections. This assessment may come from knowledge of the industry or come from fact-specific information about management. How this information gets incorporated into the valuation will depend on the engagement and the valuation analyst.

Making the distinction between the two types of risk is not always clear-cut (and some argue not possible); however, in either case, identifying the risks is critical to developing a good framework for the valuation procedures and calculations used to determine a conclusion of value.

[fn 1] Formerly Rule 201, *General Standards*.

Subject Matter Expertise—The General Standards Rule does not require a valuation analyst to have all of the skills or knowledge needed to accept and complete an engagement. The professional standards do, however, require a valuation analyst who is not sufficiently versed in a particular subject matter that is a component of an engagement to either become sufficiently conversant or consult with other professionals who have the requisite expertise.

The valuation analyst also needs to determine if there are any separate valuations necessary. It may be necessary to engage a third party specialist to value real estate, inventory, or machinery and equipment. Additional specialists can be engaged by the client, the client's attorney, or by the valuation analyst preparing the business valuation.

Engagement Letters—It is imperative that the valuation analyst and the client establish an understanding regarding the terms of the engagement including any scope limitations or restrictions on the valuation work. It is also important to communicate expectations to the client and encourage the client to do the same. Furthermore, all deliverables provided to the client should spell out any assumptions and limiting conditions utilized in the analyses. These assumptions and limiting conditions should be communicated to the client at the beginning of the engagement typically in the form of a written and signed engagement letter (see the "Engagement Letters" section that follows).

Engagement Budget—A crucial part of the engagement planning process is to consider the amount of time and effort expected to complete the project to assess the amount of the fees. If the total fee is uncertain, it is important to communicate that to the client as well. Hourly rates and billing policies should be clearly explained.

Engagement Reports—Under Statement on Standards for Valuation Services (SSVS) No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (AICPA, *Professional Standards*, VS sec. 100), a CPA valuation analyst can perform two types of engagements—a valuation engagement or a calculation engagement. Due to the limitations of a calculation engagement and the related calculation report, valuation analysts should perform only valuation engagements and prepare and submit detailed valuation reports whenever conducting a valuation for an estate and gift tax return.

Engagement Deadlines—Finally, timing and deadlines must be considered prior to accepting a valuation engagement. Valuations performed for estate and gift tax purposes need to be completed prior to the filing deadline of the tax return and with adequate time for proper review. Failure to do so may result in careless mistakes at a minimum to more significant errors or omissions that can have detrimental consequences for both the client and valuation analyst.

Engagement Letters

An engagement letter is a contract between the valuation analyst and the client. Although engagement letters are not required by guidance, they help establish a clear understanding of the roles and responsibilities of the valuation analyst and the client, which in turn helps formalize the expectations of all parties. Engagement letters may also be referred to as engagement contracts or retention agreements.

The engagement letter should include the following:

- Purpose of the valuation
- Scope of the engagement

- Valuation date
- Standard of value
- Preliminary assumptions and limiting conditions
- Parties to the contract
- Intended users of the valuation report(s)
- Level of service to be provided
- Type of report(s) to be provided
- Billing and collection terms and amounts
- Dispute resolution terms, including arbitration or mediation clauses

Valuation analysts are encouraged to seek advice from an independent attorney or a liability insurance provider when drafting their engagement letters. Furthermore, these documents should be reviewed and updated on a regular basis and, when necessary, valuation analysts should notify their malpractice carrier when introducing new services to their practice. [fn 2]

SSVS No. 1

In 2007, the AICPA Consulting Services Executive Committee issued SSVS No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (now codified in AICPA *Professional Standards* as VS section 100, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset*, and referenced as such throughout the practice aid). The standard was written to improve the consistency and quality of practice among AICPA members performing business valuations. These standards apply to AICPA members who are engaged to estimate the value of a business, business ownership interest, security, or intangible asset. Practitioners should note that many states have incorporated AICPA standards into their statutes governing professional services.

VS section 100 covers "overall engagement considerations," which include professional competence, nature and risks of the valuation services, expectations of the client, objectivity and conflict of interest, independence, establishing an understanding with the client, assumptions and limiting conditions, and scope restrictions or limitations. This also includes guidance on what a valuation analyst should consider when analyzing the subject interest, the assessment and application of appropriate valuation approaches and methods, and the preparation and maintenance of appropriate documentation.

[fn 2] Examples of engagement letters can be reviewed in the SSVS No. 1 Toolkit at www.aicpa.org/InterestAreas/ForensicAndValuation/Resources/Standards/Pages/standards-valuation-services-toolkit.aspx.

VS section 100 provides valuation analysts more structure—not only on what to include in a valuation report, but also a better defined timeframe within which the facts and circumstances should be considered relevant for purposes of the valuation report. [fn 3]

A valuation performed for a matter before a court, arbitrator, mediator, or in a governmental or administrative proceeding is exempt from the reporting provisions of VS section 100. It is worth noting, however, that the exemption applies only to the reporting provisions of VS section 100 and does not apply to the developmental provisions of VS section 100. Valuations prepared for estate and gift tax purposes do not qualify for this exemption. VS section 100 also includes appendix A, "Illustrative List of Assumptions and Limiting Conditions for a Business Valuation"; appendix B, "International Glossary of Business Valuation Terms"; and appendix C, "Glossary of Additional Terms." The valuation analyst may also consult Interpretation No. 1, "Scope of Applicable Services" (AICPA, *Professional Standards*, VS sec. 9100 par. .01–.89), of VS section 100.

Statute of Limitations and Other Audit Considerations

Valuation analysts may be retained to prepare conclusions of value for federal and state estate and gift tax returns (collectively referred to as "tax return(s)") for their clients. IRS scrutiny makes it imperative that tax returns are properly and accurately prepared on time to prevent unnecessary delays and inquiries that could have serious ramifications for clients, as well as for the professional who prepared the tax returns. The statute of limitations for the IRS to audit a tax return is generally three years from the date of filing; however, the IRS does have the ability to modify that timeline if circumstances warrant an extension. In circumstances where no tax return is filed, the statute of limitations never starts and the IRS can challenge the tax return indefinitely. If a tax return is filed but it is incomplete or the support is insufficient (for example, poor documentation, missing forms, and so on), the IRS can take the position that the statute of limitations has not yet begun and subject the tax return to an audit for as long as the IRS considers the support for the amounts disclosed in the return to be insufficient. This could result in, at a minimum, a delay in settling the decedent’s estate to much more punitive actions such as additional taxes and fines. [fn 4] Therefore, as noted earlier, in order to provide the most thorough documentation to the IRS, the valuation analyst should prepare and submit only a detailed valuation report when conducting a valuation for estate and gift tax purposes.

The following statistics should help further emphasize how important well documented valuation reports are when submitted for estate and gift tax purposes. The *Internal Revenue Service Data Book 2012* reported of the 12,582 estate tax returns filed in 2011, the IRS audit rate of these returns was 29.9 percent! Estates with assets of $5 million up to $10 million had an audit rate of 58.6 percent, and estates above $10 million had an effective audit rate of 116 percent (due to the investigation into returns filed in tax years prior to 2011). Valuation analysts should anticipate that any valuation report submitted as support for an estate and gift tax return will most likely be reviewed and audited by the IRS. Best practices

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[fn 3] See chapter 4, "Overview of Case Law," within this practice aid.

[fn 4] Title 26 of U.S. *Code of Federal Regulations* (CFR) requires that when an estate and gift tax return is filed, it must contain sufficient support for the amounts included in the return. The IRS has defined this as "adequately shown." Failure to "adequately show" the proper amounts on the return allows the IRS to audit and possibly collect additional taxes on the return at any time (that is, statute of limitations never begins). The criteria for what is considered adequately shown is provided at 26 CFR 301-6501(c)-1(e)(2) and includes, among other things, requirements to disclose (*a*) detailed description of how values were determined, (*b*) financial statements, and (*c*) relationships between all interested parties.

should ensure that all procedures and documentation be conducted in accordance with the professional standards such as VS section 100, as well as federal and state regulations.

Conclusion

Valuation analysts who invest the appropriate amount of time and effort into understanding the scope and risks of a valuation engagement will help establish a foundation for preparing reasonable and supportable conclusions of value. A critical part of that process is conducting all valuation engagements in compliance with established professional standards which will help protect the client's interests as well as the professional reputation of the valuation analyst.

Chapter 3

Overview of Pertinent Tax Code Sections and IRS Revenue Rulings

Tax guidance comes from statutory, administrative, and judicial authority. In addition to being able to locate and interpret the sources of guidance, valuation analysts must understand the relative weight of authority for each source.

Tax authority created by statute is found in the United States Code (USC). The Internal Revenue Code, formally the *Internal Revenue Code of 1986*, was codified in Title 26 of the USC. Subtitle B of Title 26 relates specifically to estate and gift taxes and includes five chapters: chapter 11, "Estate Tax"; chapter 12, "Gift Tax"; chapter 13, "Tax on Generation-Skipping Transfers"; chapter 14, "Special Valuation Rules"; and chapter 15, "Gifts and Bequests from Expatriates." Chapters 11 and 12 include provisions that impact valuations for estate or gift tax purposes. Chapter 13 establishes the rules on transferring wealth to family members who are at least one or more generations removed from the individual making the transfer (for example, grandchildren). Chapter 14 is devoted solely to special valuation rules as they relate to transfers in interests in corporations, partnerships, and trusts. This section also contains the concomitant rights and restrictions to such transfers. Due to the scope and intricacies of the rules in this chapter, the valuation analyst should be on alert that this is a complex section of the tax code that may require consultation with a subject matter expert. Chapter 15 was enacted in 2008 and established the rules for determining and paying tax on the transfer of assets by a U.S. citizen who has relinquished citizenship or by a long-term resident of the United States who is no longer lawfully a U.S. resident. Subtitle F of Title 26 contains the procedural and administrative information relating to the tax code.

Tax laws and related guidance created from administrative sources can be found in Treasury regulations, revenue rulings and revenue procedures, technical advice memoranda, and other sources. The authority from these sources ranges from having the effect of law to anecdotal information.

In its role in administering the tax laws enacted by Congress, the IRS must take the specifics of these laws and translate them into detailed regulations, rules, and procedures. The Office of Chief Counsel fills this crucial role by producing several different kinds of documents and publications that provide guidance to taxpayers. The following provides a summary of the more common guidance issued by the IRS:

- **Regulation—**A regulation is issued by the IRS and Treasury Department to provide guidance for new legislation or to address issues that arise with respect to existing IRC sections. Regulations interpret and give directions on complying with the law. Regulations are published in the Federal Register.

- **Revenue Ruling—**A revenue ruling is an official interpretation by the IRS of the IRC, related statutes, tax treaties, and regulations. It is the conclusion of the IRS on how the law is applied to a specific set of facts. Revenue rulings are published in the Internal Revenue Bulletin for the information of—and guidance to—taxpayers, IRS personnel, and tax professionals.

- **Revenue Procedure—**A revenue procedure is an official statement of a procedure that affects the rights or duties of taxpayers or other members of the public under the IRC, related statutes, tax treaties, and regulations; a revenue procedure should be a matter of public knowledge. It is also published in the Internal Revenue Bulletin. While a revenue ruling generally states an IRS position, a revenue procedure provides return filing or other instructions concerning an IRS position.

- **Private Letter Ruling (PLR)—**A PLR is a written statement issued to a taxpayer that interprets and applies tax laws to the taxpayer's specific set of facts. A PLR is issued to establish with certainty the federal tax consequences of a particular transaction before the transaction is consummated or before the taxpayer's return is filed. A PLR is issued in response to a written request submitted by a taxpayer and is binding on the IRS if the taxpayer fully and accurately described the proposed transaction in the request and carries out the transaction as described. A PLR may not be relied on as precedent by other taxpayers or IRS personnel.

- **Technical Advice Memorandum (TAM)—**A TAM is guidance furnished by the Office of Chief Counsel upon the request of an IRS director or an area director in response to technical or procedural questions that develop during a proceeding. A request for a TAM generally stems from an examination of a taxpayer's return, a consideration of a taxpayer's claim for a refund or credit, or any other matter involving a specific taxpayer under the jurisdiction of the territory manager or the area director. A TAM is issued only on closed transactions and provides the interpretation of proper application of tax laws, tax treaties, regulations, revenue rulings or other precedents. The advice rendered represents a final determination of the position of the IRS, but with respect to only the specific issue in the specific case in which the advice is issued. The TAM does not have precedential value for a taxpayer, although the district director is bound by the advice.

- **Notice—**A notice is a public pronouncement that may contain guidance that involves substantive interpretations of the IRC or other provisions of the law.

- **Announcement—**An announcement is a public pronouncement that has only immediate or short-term value. For example, announcements can be used to summarize the law or regulations without making any substantive interpretation; to state what regulations will say when they are certain to be published in the immediate future; or to notify taxpayers of the existence of an approaching deadline.

There is a lot of authoritative guidance that affects the business valuation profession. Therefore, it is important for valuation analysts to be familiar with the statutes, administrative rulings, and memoranda that can have an impact on the conclusion of value within a valuation report. The following is an overview of the significant authoritative guidance specific to estate and gift tax valuation.

Statutory Definition of Fair Market Value

One of the fundamental principles in valuation is the concept of "fair market value" and is the standard of value required for gift, estate, and income tax valuations. Section 20.2031-1(b) of the Estate Tax Regulations and section 25.2512-1 of the Gift Tax Regulations defines *fair market value* as

> [T]he price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts.

Because this definition has been codified into the sections previously noted, it is primary legal authority and is binding on courts, government, and individuals. Other notable sections of the IRC are discussed as follows.

IRC Section 170 (Subtitle A)

This section provides definitions of *qualified appraiser* and *qualified appraisal*. Although these definitions originated in the charitable contribution regulations, the Pension Protection Act of 2006 restated the definition of *qualified appraisal* and further defined the qualifications of appraisers performing tax-related valuations.

According to IRC Section 170

- a qualified appraisal is an appraisal which is treated as a qualified appraisal under regulations or other guidance, and is conducted by a qualified appraiser in accordance with generally accepted appraisal standards and any regulations or other guidance. [fn 1]

- a qualified appraiser is an individual who has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements, regularly performs appraisals for which the individual receives compensation, and meets such other requirements as may be prescribed in regulations or other guidance. [fn 2]

IRC Section 2031 (Chapter 11)

This section contains guidance on what is to be included in the decedent's gross estate for estate tax purposes. IRC Section 2031(a) states that when determining the value of a decedent's gross estate, the value of all property, real or personal, tangible or intangible, must be included.

IRC Section 2031(b) states that the value of unlisted stock and securities can be determined by taking into consideration the value of exchange traded stock or securities of corporations engaged in the same or a similar line of business.

IRC Section 2032 (Chapter 11)

This section allows the executor of an estate to elect to use an alternate valuation date. IRC Section 2032(a) states that a date six months after the decedent's death may be used to value the property as long as the use of the later date results in a lower value of the gross estate and a lower tax burden to the estate. When the alternate valuation date is elected, that date must be applied to all assets in the estate except those sold before the alternate valuation date.

IRC Section 2036 (Chapter 11)

This section is often used by the IRS to determine whether a decedent's transfer of assets prior to death should actually be included in the value of the decedent's gross estate. IRC Section 2036(a) states that the value of that property shall be included in the decedent's estate if the decedent

- has retained the possession or enjoyment of the property,

[fn 1] IRC Section 170(f)(11)(E)(i).

[fn 2] IRC Section 170(f)(11)(E)(ii). It is worth noting that the IRS does not specifically identify credentials or member organizations when it defines "qualified appraiser." Instead this section of the IRC establishes baseline criteria for professionals to meet.

- has retained the right to the income from the property,
- can control who is able to enjoy the property, or
- can control the income from the property.

IRC Section 2036 does not apply to any transfer that is part of a "bona fide sale for an adequate and full consideration in money." [fn 3] Although not directly a valuation issue, valuation analysts need to be particularly careful when assisting clients with transfers that could be subject to IRC Section 2036. If the transfers are not done properly, those assets could be clawed back into the estate with unplanned valuation and tax consequences.

IRC Section 2512 (Chapter 12)

This section governs the applicable valuation date when a gift is made. According to the Internal Revenue Code, the value of the property as of the date of the gift shall be used as the gift amount for federal tax purposes. When property is transferred for less than adequate consideration, the amount by which the property value exceeds the consideration is deemed a gift.

IRC Section 2701 (Chapter 14)

This section was enacted as part of the Omnibus Budget Reconciliation Act of 1990 to deal with specialized valuation rules that pertain to transfers of interests in corporations or partnerships when the transferor or an applicable family member (defined as any lineal descendant of any parent of the transferor or the transferor's spouse [fn 4]) retains an applicable retained interest (including a distribution, liquidation, put, call, or conversion right) after the transfer and the transferor or applicable family members (or both) control the corporation or partnership after the transfer. To avoid the implications of IRC Section 2701, a family limited partnership (FLP) needs to ensure, among other things, that all partnership allocations and distributions are done pro-rata based on the partners' ownership interests (see chapter 8, "Family Limited Partnerships and Limited Liability Companies," for more discussion on FLPs).

IRC Section 2702 (Chapter 14)

This section deals with special valuation rules that pertain to transfers of interests in trusts. IRC Section 2702(2) states that the value of any retained interest which is not a qualified interest shall be treated as being zero, and the value of a qualified interest shall be determined under IRC Section 7520. [fn 5] IRC Section 2702 defines a qualified interest as

1. any interest which consists of the right to receive fixed amounts payable no less frequently than annually,

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[fn 3] IRC Section 2036(a).

[fn 4] IRC Section 2701(b)(2)(C).

[fn 5] IRC Section 2702(a)(2).

2. any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in trust (determined annually), and

3. any non-contingent remainder interest if all of the other interests in the trust consist of interests described in list item 1 or 2. [fn 6]

IRC Section 2703 (Chapter 14)

According to Section 2703(a), property should be valued regardless of any options or agreements to acquire or use the property at a price less than the property's fair market value. Section 2703(b) provides a safe harbor from application of 2703(a) by providing that 2703(a) shall not apply to any option, agreement, right or restriction that (1) is a bona fide business arrangement, (2) is not a device meant to transfer the property at less than full consideration, and (3) has terms comparable to similar arrangements made at arm's length. Any restriction that meets the three safe harbor requirements will be considered in determining the value of the interest.

IRC Section 2704 (Chapter 14)

This section covers the treatment of lapsed voting or liquidation rights in a corporation or partnership. IRC Section 2704(1) states that if an individual holds the right immediately before the lapse and members of the individual's family have control of the entity before and after the lapse, the lapse shall be treated as a gift transfer or a transfer includible in the gross estate of the decedent, whichever is applicable. IRC Section 2704(2) defines the transfer amount as the excess of the value of all interests held by the individual immediately before the lapse, determined as if the rights were non-lapsing, over the value of such interests immediately after the lapse. IRC Section 2704(b) restricts appraisers from considering any restrictions on liquidation in excess of the prevailing state law.

IRC Section 6662 (Subtitle F)

This section provides for taxpayer penalties for the underpayment of income tax. Penalties vary based on the underpayment being "substantial underpayment" or a "gross underpayment" as defined in this section. Penalties under this section range from 20 percent of the underpayment for substantial underpayments to 40 percent of the underpayment for gross underpayments.

IRC Section 6694 (Subtitle F)

This section provides for tax preparer penalties for the preparation of any tax return that results in an understatement of a tax liability due to taking an unreasonable position as defined in this section. Penalties will be the greater of $5,000 or 50 percent of the income derived by the preparer for preparing the return.

IRC Section 6695A (Subtitle F)

This section provides for preparer penalties for the preparation of an appraisal of property used in connection with a tax return or claim for refund if the claimed value of the property results in a substantial

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[fn 6] IRC Section 2702(a)(3)(b).

valuation misstatement,[fn 7] a substantial estate or gift tax valuation misstatement,[fn 8] or a gross valuation misstatement.[fn 9] Penalties under this section range from the greater of 10 percent of the misstatement or $1,000, up to 125 percent of the misstatement.

IRC Section 6701 (Subtitle F)

This section provides for penalties on any person who aids, assists, or advises with respect to the preparation of any portion of a tax return who knows that such portion will result in a material understatement of the tax liability of another person. Penalties are $1,000 for matters related to individuals and $10,000 for matters related to corporations. This section does not require the knowledge of the taxpayer in order for the penalty to apply.

Treasury Department Circular 230[fn 10]

Circular 230 is the common name given to the body of regulations promulgated from the enabling statute found at Title 31, USC Section 330. Circular 230 is a document containing the statute and regulations detailing a tax professional’s duties and obligations while practicing before the IRS, authorizing specific sanctions for violations of the duties and obligations, and describing the procedures that apply to administrative proceedings for discipline. Title 31 seeks to ensure tax professionals possess the requisite character, reputation, qualifications, and competency to provide valuable service to clients in presenting their cases to the IRS. In short, Circular 230 consists of the "rules of engagement" for tax practice. The underlying issue in all Circular 230 cases is the tax professional’s "fitness to practice" before the IRS.

As noted previously, revenue rulings are official interpretations by the IRS of the Internal Revenue Code, related statutes, tax treaties, and regulations. Valuation analysts should take care, however, to carefully assess the applicability of a revenue ruling to their engagements because of the fact-specific interpretations.

One of the seminal revenue rulings in the valuation profession is Revenue Ruling 59-60 which is discussed in the following section.

IRS Revenue Ruling 59-60

This ruling provides guidance regarding the valuation of the stock of closely held corporations or the stock of corporations where market quotations are not available.

According to Revenue Ruling 59-60, property included in the gross estate, or made the subject of a gift, shall be taxed on the basis of the property value at the time of the decedent’s death, the alternate valuation date if elected, or the date of the gift. Revenue Ruling 59-60 states that a determination of fair market value will depend on the circumstances in each case. Sound valuations will be based upon all relevant facts, but common sense, informed judgment, and reasonableness must enter into the process of

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[fn 7] Within the meaning of IRC Section 6662(e).

[fn 8] Within the meaning of IRC Section 6662(g).

[fn 9] Within the meaning of IRC Section 6662(h).

[fn 10] For details see www.irs.gov/Tax-Professionals/FAQs:-Enrolled-Agent-Continuing-Education-Requirements.

weighing those facts and determining their significance. In addition, Revenue Ruling 59-60 explicitly states that, "No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases."

The ruling includes eight factors that "require careful analysis in each case":

1. The nature of the business and the history of the enterprise from its inception.
2. The economic outlook in general and the condition and outlook of the specific industry in particular.
3. The book value of the stock and the financial condition of the business.
4. The earnings capacity of the company.
5. The dividend-paying capacity.
6. Whether or not the enterprise has goodwill or other intangible value.
7. Sales of the stock and size of the block of stock to be valued.
8. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

Revenue Ruling 59-60 includes a definition of *fair market value* that is similar to the definition found in Section 20.2031-1(b) of the Estate Tax Regulations and Section 25.2512-1 of the Gift Tax Regulations discussed previously.

Revenue Ruling 59-60 also includes a discussion of when restrictive agreements such as buy-sell agreements would or would not be determinative of fair market value for estate and gift tax purposes.

Revenue Ruling 59-60 was later modified by Revenue Ruling 65-193, and amplified by Revenue Ruling 77-287, Revenue Ruling 80-213, and Revenue Ruling 83-120.

IRS Revenue Ruling 65-193

Revenue Ruling 65-193 modifies Revenue Ruling 59-60 to delete statements in section 4.02(f), that "[i]n some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets." [fn 11] Revenue Ruling 65-193 goes on to state, "[t]he instances where it is not possible to make a separate appraisal of the tangible and intangible assets of a business are rare and each case varies from the other. No rule can be devised which will be generally applicable to such cases."

[fn 11] IRS Revenue Ruling 59-60(4)(02).

IRS Revenue Ruling 68-609

Revenue Ruling 68-609 supersedes Appeals and Review Memorandum (A.R.M.) 34, A.R.M. 68, O.D. 937, and Revenue Ruling 65-192. Revenue Ruling 68-609 also updates and restates the currently outstanding portions of A.R.M. 34, A.R.M. 68, and O.D. 937. According to Revenue Ruling 68-609, the "formula" approach may be used in determining the fair market value of intangible assets of a business only if there is no better basis available for determining their value.

IRS Revenue Ruling 77-287

Revenue Ruling 77-287 amended Revenue Ruling 59-60 and provides guidance for the valuation, for federal tax purposes "of securities that cannot be immediately resold because they are restricted from resale pursuant to federal securities laws." [fn 12] These restrictions reduce the marketability of the securities and therefore the securities may need to be discounted accordingly. All relevant facts and circumstances that impact the value of the restricted stock, such as the documents or agreements relating to the restrictions and other factors discussed in Section 4 of Revenue Ruling 59-60, must be taken into account when arriving at the restricted stock's fair market value.

IRS Revenue Ruling 80-213

This revenue ruling also amended Revenue Ruling 59-60 by providing information and guidance to those concerned with the valuation of a subsidiary corporation's stock that is distributed to the shareholders of a former parent corporation when the shares of both the parent and subsidiary can only be transferred as a unit. Revenue Ruling 80-213 lists factors, in addition to those mentioned in Revenue Ruling 59-60, which should be considered in valuing such "stapled" stock.

IRS Revenue Ruling 83-120

This revenue ruling further amended Revenue Ruling 59-60 by specifying additional factors to be considered in valuing the common and preferred stock of a closely held corporation for gift tax and other purposes in a recapitalization of a closely held business. Revenue Ruling 83-120 (4) (01) states that "in general, the most important factors to be considered in determining the value of preferred stock are its yield, dividend coverage, and protection of its liquidation preference." [fn 13] Other factors must also be considered, such as the ability of the issuing company to pay the full liquidation preference at liquidation, if the preferred stock has voting rights or redemptive privileges, and whether or not there are unusual covenants or provisions of the preferred stock that may affect the stock's marketability. Section (5) (01) of Revenue Ruling 83-120 states that if the preferred stock has a fixed dividend rate and is nonparticipating, "common stock has the exclusive right to the benefits of future appreciation of the value of the corporation." [fn 14] The value of that benefit depends on the company's historical growth trends, general economic conditions, and the conditions of the company's specific industry.

IRS Revenue Ruling 93-12

[fn 12] IRS Revenue Ruling 77-287.

[fn 13] IRS Revenue Ruling 83-120(4)(01).

[fn 14] IRS Revenue Ruling 83-120(5)(01).

This revenue ruling allows a minority interest discount to be applied to the valuation of a gift of a minority interest in a closely held corporation between family members even if the family members as a group control the corporation. The ruling cites the definition of *fair market value* found in Section 25.2512-1 of the Gift Tax Regulations as support. Revenue Ruling 93-12 supersedes Revenue Ruling 81-253, which previously did not allow for minority discounts if the family unit maintained control of the corporation after the transfer.

Adequate Disclosure of Gifts

In 1999, the IRS issued regulations regarding adequate disclosure of gifts on gift tax returns. These regulations include a three-year statute of limitations beyond which the IRS cannot challenge a gift tax return provided that the gifts were adequately disclosed. The regulations provide a list of information that must be reported on a gift tax return (or in an attached statement) in order for the gift to be considered adequately disclosed. In lieu of providing the required information, the regulations allow for the attachment of a business valuation report. In order to satisfy the adequate disclosure requirements, the business valuation report must meet the following requirements:

1. The appraisal is prepared by an appraiser who satisfies all of the following requirements:

    a. The appraiser is an individual who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis.

    b. The appraiser is qualified to make appraisals of the type of property being valued because of his or her qualifications, as described in the appraisal that details the appraiser's background, experience, education, and membership, if any, in professional appraisal associations.

    c. The appraiser is not any of the following people:

        i. A donor or donee of the property

        ii. A family member of the donor or donee

        iii. A person employed by the donor, the donee, or a member of the family of either

2. The appraisal contains all of the following:

    a. The transfer date, the date on which the transferred property was appraised, and the purpose of the appraisal.

    b. A description of the property which includes necessary information.

    c. A description of the appraisal process employed with the following details:

        i. Assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions.

    d. The information considered in determining the appraised value, including (in the case of an ownership interest in a business) all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value.

e. The appraisal procedures that were followed, and the reasoning that supports the analyses, opinions, and conclusions.

f. The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred.

g. The specific basis for the valuation (such as specific comparable sales or transactions), sales of similar interests, asset-based approaches, merger-acquisition transactions, and so on.

These requirements should be considered baseline criteria because the IRS may require additional information. This would be decided on a case-by-case basis.

Technical Advice Memorandum (TAM) 9436005

This memorandum addresses the premium that may be assigned to swing vote positions. In the TAM, the IRS emphasized that if minority interest holders could band together to gain control of a company, a swing vote premium would be appropriate for those interests.

Conclusion

Statutes and IRS rulings related to fair market value play an integral part of any valuation engagement, especially when dealing with estate and gift tax issues. It is important for valuation analysts to know what statutes and IRS decisions are relevant for any given engagement. Furthermore, it is also extremely important for valuation analysts to be cognizant of the scope and limitations a particular statute, ruling, or authoritative publication of any kind has when referencing any of these within a valuation report.

Chapter 4

Overview of Case Law

Precedence of Court Cases

When the IRS questions a tax matter, the IRS requires the taxpayer to undergo an audit. If the taxpayer disagrees with the result, he or she can take the case to the appellate division of the IRS. If the taxpayer disagrees with the conclusion of the appellate division, he or she must resolve the matter in U.S. District Court or U.S. Tax Court.

In order for a dispute to be heard by the U.S. District Court, the taxpayer must first pay the disputed amount and then file a claim for a refund from the IRS. If the IRS denies the refund claim and various administrative remedies have been exhausted, the taxpayer can file a suit for a refund within the jurisdiction of the U.S. District Court, where the taxpayer has the right to request a jury trial. No minimum threshold for tax disputes exists in the U.S. District Court, but the court typically handles more complex cases that involve larger disputed amounts when compared to the U.S. Tax Court. [fn 1]

The second option, and the one venue individual taxpayers select more frequently, is the U.S. Tax Court. Taxpayers usually choose this venue because they do not have to pay the tax before filing a claim. A Tax Court case commences with the filing of a petition within 90 days after the IRS mails the taxpayer a deficiency notice. Once the petition has been filed, the taxpayer is not required to remit payment of the tax proposed by the IRS until the case has been decided.

The Tax Court is made up of 19 judges appointed for a 15-year term by the president. Although the court resides in Washington, D.C., the judges travel around the country to hear cases in approximately 75 cities. While Tax Court judges can issue their decisions from the bench, they return to their offices to write their opinions in most cases. Bench opinions are binding only on the parties in the trial and form no precedent.

Many of the cases filed in Tax Court are small Tax Court procedures which involve tax disputes of $50,000 or less. In these cases, the judges render summary opinions that cannot be appealed. However, before the decision is rendered, the taxpayer can transfer the case to the regular Tax Court where recourse to an appeal is available. [fn 2]

When a judge renders an opinion in the Tax Court, it is reviewed by the chief Tax Court judge who works with his or her counsel, composed of two judges. The chief judge decides whether the case should be referred to a review by all 19 judges or if it should be released as a memorandum opinion. A memo-

[fn 1] Another venue for tax dispute resolution is the U.S. Court of Claims. Trials in this court system are heard only by a judge and taxpayers cannot seek a refund of certain IRS penalty payments. While individuals are permitted to have claims heard in the U.S. Court of Claims, large national and multi-national companies predominately utilize this venue.

[fn 2] Tax Court opinions and decisions are not the same. An *opinion* is filed by the Tax Court and is the written determination that documents the issues tried and submitted to the Tax Court for decision. The *decision* is based on the opinion of the Tax Court and is the court's determination of either the taxpayer's deficiency or overpayment. An appeal, if allowed, is done based on the Tax Court's decision, not opinion.

randum opinion does not involve any new legal issues and generally addresses cases in which the law is settled or the facts are not unusual. It is appealable and can be cited as legal authority; however, it does not create precedent.

The Tax Court can also issue Tax Court opinions. These are issued when the court believes that an important legal issue has not been previously decided, in which a judge proposes to overrule a prior case, or when a case has been reversed by a court of appeals. This type of opinion is also used if the Tax Court proposes to invalidate an IRC Regulation. The chief judge will call for a court review when the result may be controversial, or when the chief judge is made aware of differences of opinion among the judges. Tax Court opinions are appealed and can be cited as precedent.

If U.S. Tax Court, U.S. District Court, or U.S. Court of Claims cases are appealed, they are appealed to the U.S. Court of Appeals where either the taxpayer lives or the business is domiciled. There are 11 regional courts of appeal, a D.C. Circuit Court of Appeals, and the U.S. Court of Appeals for the federal circuit, which has jurisdiction over certain appeals based on the subject matter of the case. U.S. Court of Appeals decisions serve as precedent only in that circuit. They do not bind Tax Court judges or U.S. Court of Appeals judges in other circuits.

Valuation Analysts Use of Court Cases

Court cases are legal decisions that are based on the facts and circumstances presented to the court at the time of the trial. Under Tax Court Rule 143G, an expert's report is generally the expert's direct testimony which is then subject to cross-examination. It is rare that the reader of a court case, regardless of the jurisdiction, will have access to the valuation reports submitted to the court by the valuation expert(s). It is important that the valuation analyst who reviews a legal decision for guidance on how to conduct a valuation engagement be cognizant of the fact that the court's decision has more than likely summarized the expert's assumptions, approaches, methodologies, and so on, and included only the relevant portions of the expert's report. As a result, the valuation analyst reading the court decision will have only partial insight into the procedures used by the valuation expert and facts and circumstances used by the court to render the decision. Although valuation issues arise in many court cases, the issues argued in these cases are primarily legal ones. Most valuation analysts do not have the requisite training to thoroughly evaluate the legal positions presented and how the valuation evidence relates to it. Therefore, valuation analysts must be cautious and not place too much reliance on court cases at the risk that the case may not be appropriate for the specific facts and circumstances of the specific engagement.

That said, it is important that the valuation analyst working in the estate and gift tax arena read court cases as they are issued and, at a minimum, understand the issues that the IRS believes are important enough to audit. In many cases though, the valuation issue is tangential to legal arguments (such as IRC Section 2036 issues where the valuation becomes important only if the taxpayer prevails on this legal issue).

Valuation analysts must also be mindful of how courts may respond to significant use of citation and reliance on case law by a valuation analyst. An example of how the use of case law can be perceived by a court is best illustrated by comments from Judge Laro of the Tax Court. He has said on numerous occasions that he does not like when valuation analysts cite court cases; he believes it is inappropriate for individuals who are not attorneys to be seen as "practicing law." However, he has also said that valuation analysts should be aware of his cases and, when appropriate, consider them, in particular, the factors he provides in *Bernard Mandelbaum, et al. v. Commissioner*, T.C. Memo 1995-255 (see chapter 7, "Discount for Lack of Marketability," for further analysis of this decision).

Blind reliance on even well-established factors like those found in *Mandelbaum* can lead to unintended, and likely unfavorable, results. For example, in *Peter S. Peracchio v. Commissioner*, T.C. Memo 2003-280, Judge Halpern stated

> To the extent [the appraiser] believes that the benchmark range of discounts we utilized in *Mandelbaum v. Commissioner*, *supra*, is controlling in this or any other case, he is mistaken. Nothing in *Mandelbaum* suggests that we ascertained that range of discounts for any purpose other than the resolution of that case. To the contrary, we specifically stated that we were using the upper and lower limits of that range 'as benchmarks of the marketability discount for the shares at hand.' If, instead, [the appraiser] simply believes that such range of discounts is equally appropriate under the facts of this case, he offers no justification whatsoever for that view. We believe he would be hard pressed to do so; the entity at issue in *Mandelbaum*, an established operating company, bears little resemblance to the partnership.

This is the good example of a valuation analyst relying on a case that did not adequately support his position. As stated earlier in this chapter, Tax Court memorandum cases can be cited as legal authority, but they do not create precedent. In addition, the *Mandelbaum* case dealt with discounts for lack of marketability in an operating business, whereas the *Peracchio* case dealt with a holding company. Judge Halpern clearly was not persuaded that the same factors were appropriate for the two types of entities. The important lesson from this example is that valuation analysts should carefully review case law with professionals who are well versed in valuation case law when appropriate, especially if there is any doubt about the use of case law to support a conclusion of value.

Issues in Tax Court Cases

Over the years, the Tax Court and U.S. District Court have dealt with a variety of valuation issues—some of which are discussed in the following text.

Standard of Value

In the estate and gift tax arena, the required standard of value is fair market value. Courts do not always understand this value concept and, as a result, apply it incorrectly as illustrated in *Estate of Alice Friedlander Kaufman v. Commissioner,* T.C. Memo 1999-119, which was appealed to the 9th Circuit Court of Appeals (*Morrissey, et al. v. Commissioner*, No. 99-71013 [9th Circuit, March 15, 2001]). In the original case, the court ruled in favor of the IRS on the value of an interest in an operating company. The valuation analyst for the taxpayer had considered two transactions of the company's stock that had occurred shortly after the valuation date, which the court rejected stating that they were "not sufficiently similar to the estate's much larger 21.51 percent interest to make their sales price representative of the value of the estate's stock."

The taxpayers appealed the decision to the 9th Circuit which reversed and remanded the Tax Court's decision stating that the two sales that occurred soon after the date of death were at arm's length and should be considered when determining the fair value of the stock. Some of the court's remarks follow:

> [Definition of fair market value]. The willing buyer and willing seller are to be postulated, not as a particular named X or Y, but objectively and impersonally. As the Tax Court itself has held, the Commissioner cannot 'tailor hypothetical' so that the willing seller and willing buyer were seen as the particular persons who would most likely undertake the transaction.' Actual sales between a willing seller and buyer are evidence of what the hypothetical buyer and seller would agree on. [citations omitted]. No good reason existed to reject the sales by Branch and Hoffman

> as evidence of the fair market value of Seminole stock on April 14, 1994. The sales took place close to the valuation date. The sellers were under no compulsion to sell. There was no reason for them to doubt [the valuation analyst's] report of the Merrill Lynch valuation. That the final report was delivered only in July did not undercut the weight of the formal opinion letter written in March. The sellers had no obligation to hire another investment firm to duplicate Merrill Lynch's work.

The court went on to say that the value of the transferred stock "at the moment [the decedent] transferred it by death cannot be determined by imagining a special kind of purchaser for her stock, one positioning himself to gain eventual control or force the family to buy him out."

The definition of *fair market value* and its interpretations are clear in that it supposes a transaction between an assumed willing buyer and assumed willing seller. It also suggests that actual transactions of the stock, if at arm's length, can be used as an indication of value. The 9th Circuit was very clear that the Tax Court did not consider the correct definition of *fair market value* when it rendered its decision, which is why it reversed the Tax Court's decision.

Subsequent Events

Subsequent events are simply events that happen after the valuation date. While the definition is self-explanatory, how this concept gets applied to valuations used in estate and gift tax engagements can be complicated. Prior to the issuance of Statement on Standards for Valuation Services (SSVS) No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (now codified in AICPA *Professional Standards* as VS section 100), valuation analysts had the latitude to include events occurring after the valuation date in their determination of fair market value, even if they had no prior knowledge of the event. When SSVS No. 1 was issued in 2007, the standard required valuation analysts to consider only elements of a valuation that were known or knowable on the valuation date.[fn 3] This, of course, may include events or transactions that occur after the valuation date provided the "known or knowable" criterion is met. Events and circumstances that do not meet this criterion must be precluded from the valuation. VS section 100 does permit disclosure of subsequent events when the valuation analyst determines the events are meaningful to the user of the report; however, they must be included in a separate section of the report and must clearly state the disclosures are for "informational purposes only and do not affect the determination of value as of the specified valuation date."[fn 4] While SSVS No. 1 establishes relatively well defined guidance for including or excluding subsequent events, the evidentiary rules courts follow when deciding on issues of fair market value allow for a wider spectrum of permissible facts and circumstances.

In the *Estate of Helen M. Noble, v. Commissioner* (*Noble*),[fn 5] there were three transactions in decedent's shares of closely held stock that were reviewed to help value shares of the same company in the decedent's estate on the valuation date. The petitioner (Estate of H. Noble) took the position that only transactions in the stock that occur prior to the valuation date should be considered when determining

[fn 3] VS section 100, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (AICPA, *Professional Standards*), paragraph 43.

[fn 4] VS section 100 paragraph 43.

[fn 5] See *Estate of Helen M. Noble v. Commissioner*, T.C. Memo 2005-2 (January 6, 2005).

fair market value. The court disagreed. The judge in *Noble* allowed a transaction that was 14 months past the valuation date to assist in determining fair market value and stated:

> [W]e disagree with petitioners that only sales of stock that predate a valuation date may be used to determine fair market value as of that valuation date. The Court of Appeals for the 8th Circuit, the court to which an appeal of this case most likely lies, has held specifically that 'In determining the value of unlisted stocks, actual sales made in reasonable amounts at arm's length, in the normal course of business, within a reasonable time before or after the basic date, are the best criterion of market value' (citations omitted). [fn 6]

The opinion went on to note that events occurring after the valuation date—even those deemed to be unforeseeable—may still be relevant in determining fair market value at an earlier date if the evidence is probative of the earlier valuation and helps establish a transaction amount between a hypothetical willing buyer and willing seller for the subject property on the valuation date. Federal Rules of Evidence, which the federal courts are required to follow, define evidence as being "relevant" if it has "any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without that evidence." [fn 7]

Whether evidence relating to subsequent events is admissible by the courts in determining the fair market value on an earlier date is an issue of relevance. Most subsequent events are not relevant because the "measure of tax must be determined according to the situation as it existed on the date [in question], and not according to subsequent events." But subsequent events that shed light on what a willing buyer would have paid on the date in question are admissible, such as "evidence of actual sales prices received for property after the date [in question], so long as the sale occurred within a reasonable time... and no intervening events drastically changed the value of the property." [fn 8]

When evaluating subsequent events, valuation analysts need to consider what was known or knowable but should also do their best to determine if there were any transactions or events that would have been unknowable on the valuation date and be viewed by the courts to offer probative value to the conclusion of value on the valuation date. In situations where this type of information might exist, valuation analysts must be prepared to support why (or why not) certain information or events should (or should not) be included (or excluded) as known or knowable facts at the valuation date.

Discounts and Premiums

There are numerous cases used by valuation analysts in their valuation reports that deal with issues such as control premiums, discounts for lack of control (DLOC), discounts for lack of marketability (DLOM), blockage discounts, fractional interest discounts, as well as miscellaneous other discounts. As noted

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[fn 6] The 8th Circuit case referred to was the *Estate of Fitts v. Commissioner*, 237 F.2d 729 (October 30, 1956). In this case, the petitioner valued the closely held stock at $150 per share while the Commissioner valued it at $600 per share. The court determined the fair market value was $375 per share. It is not clear from the opinion if the judge reviewed subsequent transaction in the company's closely held stock (in fact, the dissenting opinion suggests the court just split the difference between the two values to arrive at its final fair market value). The court did, however, cite treasury regulations found in Section 20.2031-2 as support for considering post-valuation date transactions when assessing fair market value.

[fn 7] See Fed. R. Evid. 401.

[fn 8] See *Estate of Helen M. Noble v. Commissioner*, T.C. Memo 2005-2 (January 6, 2005).

throughout this practice aid, valuation analysts often use case law and academic studies to provide support and direction for their own valuation reports; however, this practice (without further investigation into the specific facts of each case, the methodologies used by the valuation experts, and the rigor used to compile any academic study) will more likely than not result in conclusions of value that do not withstand the scrutiny of the courts. Because DLOC and DLOM can require a lot of professional judgment, valuation analysts must make every effort to ensure their discounts are reasonable and well supported. The case of *Estate of Webster E. Kelley, et al. v. Commissioner*, T.C. Memo 2005-235 is an expository example of what can happen when this is not done.

Most of the issues in this case were resolved before trial, and therefore, the remaining issue was whether the proper discounts were applied to a minority interest in an FLP that solely held cash. The experts' discounts were as follows.

	DLOC	*DLOM*
Taxpayer	25%	38%
IRS	12%	15%

In its decision, the court ruled in favor of the IRS and noted that, "Although we find neither expert particularly persuasive on this issue, we will apply a 12-percent discount on the grounds that (1) respondent has effectively conceded that a discount factor of up to 12 percent would be appropriate, and (2) petitioner has failed to prove that a figure greater than 12 percent would be appropriate. See *Peracchio v. Commissioner*, supra (using a 2-percent minority discount factor for the 'cash and money market funds' asset category of a family limited partnership)." On the issue of the DLOM, the court determined that a DLOM of 20 percent was appropriate and its decision was based on same rationale used to decide on the issue of which discount rate was appropriate.

While there is no guarantee the results would have been different had the valuation analyst prepared a more thoroughly supported valuation report, the valuation analyst's lack of analysis and support were clearly a factor in how this judge ruled on the issues.

Tax-Affecting in Subchapter S Corporations

Historically, valuation analysts took the position that the assumed buyer of a subchapter S corporation or an interest in this type of corporation would be a C corporation or other ineligible shareholder and therefore, a C corporation level of taxation was applied to adjusted earnings when valuing an S corporation. In addition, it is common practice for valuation analysts to use the discount rates derived from the data contained in *Stocks, Bonds, Bills and Inflation* and the *Duff and Phelps Risk Premium Report* when valuing the corporation's after-tax net cash flow.

In 1999, the Tax Court ruled in the case of *Walter L. Gross, Jr., et ux., et al. v. Commissioner* (*Gross*), T.C. Memo 1999-254 that the net income of a subchapter S corporation should not be tax-affected because the corporation would not pay taxes. This case was appealed to and upheld by the 6th Circuit Court of Appeals (88 AFTER 2d 2001-6858[272 F.3d 331]). Several additional cases have followed this decision that have not allowed tax-affecting of subchapter S corporations. Three of these cases were decided by the same judge that heard the *Gross* case.

Before deciding on whether to tax-affect an S corporation for valuation purposes, valuation analysts should consider the facts and circumstances surrounding each valuation assignment. As stated throughout this practice aid, courts rule on the facts presented to them and these facts will be unique in each case. Valuation analysts must perform their analyses based on the unique factors of the particular assignment with the understanding that established case law may not necessarily apply to their engagement because the facts and circumstances are different or no established precedent exists in their jurisdiction.

To illustrate how much variation exists from court to court, a roundtable of various Tax Court judges that convened in 2011 indicated that tax-affecting an earnings stream might be appropriate if the right facts and circumstances along with a supportable opinion of value, which includes the proper support of the application of taxes, was presented to them.[fn 9] Court decisions and memorandum cases that have been decided subsequent to the roundtable suggest the fact-and-circumstance approach is widely used in practice. Valuation analysts should note that, as of the date of this publication, the *Gross* case is the only case that has been appealed and therefore only the 6th Circuit Court of Appeals has issued an opinion on this issue.

Conclusion

This chapter touches on some of the prevailing valuation issues in the tax and district courts, but it in no way addresses all possible issues. Each case is fact-specific and so the valuation analyst should conduct his or her own search for relevant cases that may provide guidance on what the courts look for when deciding on the legitimacy of FLPs and transfers of interests in the same to beneficiaries. Furthermore, consideration should be given on the need to consult with subject matter experts in both the financial and legal professions. A list of additional cases of interest is provided in appendix B, “Common Acronyms Used in This Practice Aid.”

[fn 9] *Judges Roundtable: View from the Bench*, November 3, 2011 (Business Valuation Resources).

Chapter 5

Elements and Attributes of Reports

This chapter discusses the elements and attributes of a valuation report that are considered to be best practices. It is recommended that valuation reports prepared for estate and gift tax purposes follow the reporting provisions of VS section 100, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (AICPA, *Professional Standards*). Although a full discussion of the requirements of VS section 100 is beyond the scope of this practice aid, there are certain items that are particularly important in documenting a valuation for estate and gift tax purposes.

The business valuation report that is attached to the gift or estate tax return serves as support for the fair market value of a specific asset reported on the tax return. It is usually the only document presented to the IRS that will be used to determine whether the related asset's fair market value reported on the return should be accepted as filed or should be challenged. The IRS business valuation guidelines [fn 1] state that "the primary objective of a valuation report is to provide convincing and compelling support for the conclusions reached." It is the taxpayer's best opportunity to persuade the IRS that the value reported is correct and should be accepted.

An effective estate or gift tax valuation report should be both well-written and well-organized. VS section 100 describes three report types: (1) detailed report, (2) summary report, and (3) calculation report. For estate and gift tax purposes, valuation analysts should prepare only written detailed reports to ensure the IRS receives the most comprehensive support for the values presented in the tax return. Therefore, this practice aid will address only the preparation of a detailed report for a valuation engagement that expresses a conclusion of value.

When dealing strictly with federal gift tax returns, the United States Treasury Department has promulgated regulations that require adequate disclosure of all gifts that are in excess of the annual exclusion amount in the year the gift is made. Given the robust disclosure requirements needed to support present interest assertions and valuations, the taxpayer is serving in his or her best interest by retaining a valuation analyst to prepare and submit detailed valuation report to the IRS.

These regulations do not apply to estate tax returns and are not codified in any rules or regulations that apply to estate tax returns; however, there are similar disclosure and documentation requirements that carry their own penalties for non-compliance. The estate's executor, with the valuation analyst's assistance, should always submit a detailed report with the estate tax return to help mitigate subsequent inquiries and requests for supporting documentation from taxing authorities and to ensure that the statute of limitations begins on the timeline the IRS can conduct an audit of the return. [fn 2]

[fn 1] Department of the Treasury, Internal Revenue Service, IRM 4.48.4, Engineering Program, Business Valuation Guidelines 4.1.1, Issued July 1, 2006.

[fn 2] See earlier discussion on this topic in chapter 1, "Scope."

VS section 100 paragraphs .51–.70 provide guidance on the components to be included in a detailed report, much of which is self-explanatory. Although there is no required sequence for the report components, the report must flow in a logical, sensible manner that is easily followed by the reader.

VS section 100 paragraph .51 states

> The detailed report is structured to provide sufficient information to permit intended users to understand the data, reasoning, and analyses underlying the valuation analyst's conclusion of value. A detailed report should include, as applicable, the following sections titled using wording similar in content to those shown:
>
> - Letter of transmittal
> - Table of contents
> - Introduction
> - Sources of information
> - Analyses of the subject entity and related nonfinancial information
> - Financial statement and information analyses
> - Valuation approaches and methods considered
> - Valuation approaches and methods used
> - Valuation adjustments
> - Non-operating assets, non-operating liabilities, and excess or deficient operating assets, if any
> - Representation of the valuation analyst
> - Reconciliation of estimates and conclusion of value
> - Qualifications of the valuation analyst
> - Appendixes and exhibits

A valuation report must persuade the intended user (for example, IRS, Tax Court) that the information and analyses present a conclusion that is reasonable, supportable, and replicable. To prepare a valuation report with this logical structure, the valuation analyst must clearly document each step, from the collection of the raw data to the synthesis and conclusion of value. This framework will help show the user that careful attention was given to all aspects of the report.

VS section 100 paragraph .52 suggests the following information be provided in the introduction section of the report so that the intended user can understand the nature and scope of the valuation engagement, as well as the work performed:

a. Identity of the client

b. Purpose and intended use of the valuation

c. Intended users of the valuation

d. Identity of the subject entity

e. Description of the subject interest

f. Whether the business interest has ownership control characteristics and its degree of marketability

g. Valuation date

h. Report date

i. Type of report issued

j. Applicable premise of value

k. Applicable standard of value

l. Assumptions and limiting conditions

m. Any restrictions or limitations in the scope of work or data available for analyses

n. Any hypothetical conditions used in the valuation engagement, including the bases for their use

o. If the work of a specialist was used in the valuation engagement, a description of how the specialist's work was relied upon

p. Disclosure of subsequent events in certain circumstances

q. Any application of the jurisdictional exception

r. Any additional information the valuation analyst deems useful to enable the user(s) of the report to understand the work performed.

The analyses and descriptions of the subject entity's finances and operations should include recent balance sheets, income statements, and cash flow statements, if available. Furthermore, the analyses should incorporate, to the extent available, historical financial statements for a look-back period that is sufficient enough to allow identification of entity-specific trends.

The detailed valuation report should also include a discussion of the industry and economic trends and, ideally, supportable and relevant reasons for the trends, rather than a simple recitation of the facts or boilerplate descriptions. The purpose of this is to help develop the valuation analyst's assessment of the entity's future outlook which is especially important if a company is valued using an income or a market approach. Forecasts and exit multiples must be reasonable and supportable. If a valuation analyst can show correlations or other kinds of relationships between the entity and external micro and macro influences, this information can be used to explain an entity's potential in the future and ultimately a step in the right direction for establishing a well-supported conclusion of value.

In addition to analyzing the entity's historical financial results, a detailed report should also include a comparison of the entity's financial results against industry benchmarks and comparable companies. These analyses are more effective when they include historical data looking back over a period of several years rather than the most recent year or two because this will give more weight to any statement that refers to industry data and results to support conclusions about the entity's financial results or forecasts. For consistency purposes, it is important the valuation analyst uses comparable timelines for the entity's historical trends and the industry's trends. This will help identify trend correlations and deviations between the entity and its related industry, as well as any other micro- or macro-economic influences. As noted before, the valuation analyst should describe how these analyses support the conclusion of value. Sensitivity or stress testing should be incorporated into this process when appropriate. Graphs and charts may also be useful in presenting the results of the subject analyses; however, they should help explain the data, analyses, and conclusions reached in the valuation report and not be relied on as a substitute for supporting details.

To further establish comparability of a company's historical financial statements to relevant benchmarks, valuation analysts should assess whether the financial data presented in the detailed valuation report should be adjusted when unusual or extraordinary events that significantly impact operations or financial results (or both) exist. It will be up to the valuation analyst to support the normalizing adjustment with historical operating results, discussions with management, and so on. If a conclusion is reached that an adjustment is required, the valuation analyst must determine the magnitude of the adjustment in order to arrive at normalized operating results. For every such adjustment, the valuation analyst should explain the circumstances giving rise to each adjustment, the reasoning for making each adjustment, and the impact of the adjustment.

In the detailed valuation report, the valuation analyst should discuss the consideration of the three valuation approaches (that is, income, market, and asset), which valuation methods were considered, and the reasons why each is, or is not, applicable for the conclusion of value.

For example, if the income approach is appropriate, the valuation analyst should clearly define the benefit stream being used and how the future levels of the benefit stream were derived. When developing a discount rate or capitalization rate, the valuation analyst must make sure the detailed valuation report identifies the sources for all inputs, such as the risk-free rate, the equity risk premium, and so on. Such citations (usually in footnotes) should be complete and permit the reader to replicate the analyses. In instances where the data cannot be supported by empirical data (for example, components of non-diversified risk) the valuation analyst must apply professional judgment. In these cases, the valuation analyst's methodologies should be fully explained in enough detail to allow the reader to conclude on the reasonableness of the valuation analyst's results.

If indications of value are derived from multiple methods, the valuation analyst should reconcile the values from each method to the concluded value presented in the report with sufficient detail to permit the reader to assess the reliability of the resulting conclusion of value. [fn 3]

[fn 3] As noted in chapter 2, 26 (U.S.) *Code of Federal Regulations* 301.6501(c)-1(e)(2) requires appropriate level of detail in the report to meet the "adequately shown" threshold. A reconciliation between multiple methods is recommended to help satisfy that requirement.

Finally, in order not to detract from the valuation report's credibility, the valuation analyst must be diligent about the smaller details like syntax, punctuation, proper calculations, and so on. Common or careless mistakes, although minor, may have no impact, or immaterial impact, on the conclusions reached, but can have significant impact on the readers of the report and their perception of the report's accuracy. Common examples of where errors may be found include, but are not limited to, (*a*) matching the discount or capitalization rate to the incorrect economic income measure, (*b*) arithmetic errors, and (*c*) use of inconsistent rounding conventions. Finally, it is also important make sure the overall report is reasonable and tells a consistent story from beginning to end. An objective review from someone not exposed to the details or day-to-day preparation of the report is often an effective way to assess how the report will read to intended users. Obviously this review must be conducted by someone who is permitted to review client information without jeopardizing confidentiality.

When drafting the report's narrative, consider using the following composition guidelines:

- Appropriate level of formality in the report
- Gender-neutral references
- Correct punctuation
- Active voice
- Consistent verb tenses
- Coherent prose in the valuation report (to clearly link related ideas and distinguish from unrelated ideas)

Conclusion

The detailed valuation report is the most important evidential support for conclusions of value submitted with an estate and gift tax return. Therefore, commensurate time and effort should be expended when preparing this report.

Chapter 6

Control Versus Lack of Control

Introduction

The primary goal of estate planning is to maximize the wealth transferred to beneficiaries and minimize the taxes paid to government. Two widely used methods that achieve this goal include the use of discounts for lack of marketability and lack of control. Both of these discounts, in combination with other estate planning strategies, can have significant impact on the value of a transferred interest. The courts have recognized the use of discounts for lack of control as an accepted technique to minimize estate and gift tax liabilities; however, the courts (and the IRS) recognize the high level of judgment required and as a result, they heavily scrutinize such discounts. This chapter includes a discussion of the factors that should be considered when valuing ownership interests using common valuation approaches and methods.

Levels of Value

Valuation adjustments for discounts and premiums must be considered in the context of ownership control and marketability of the ownership interests. Ownership characteristics and the value they reflect are often illustrated using a "levels of value" chart.

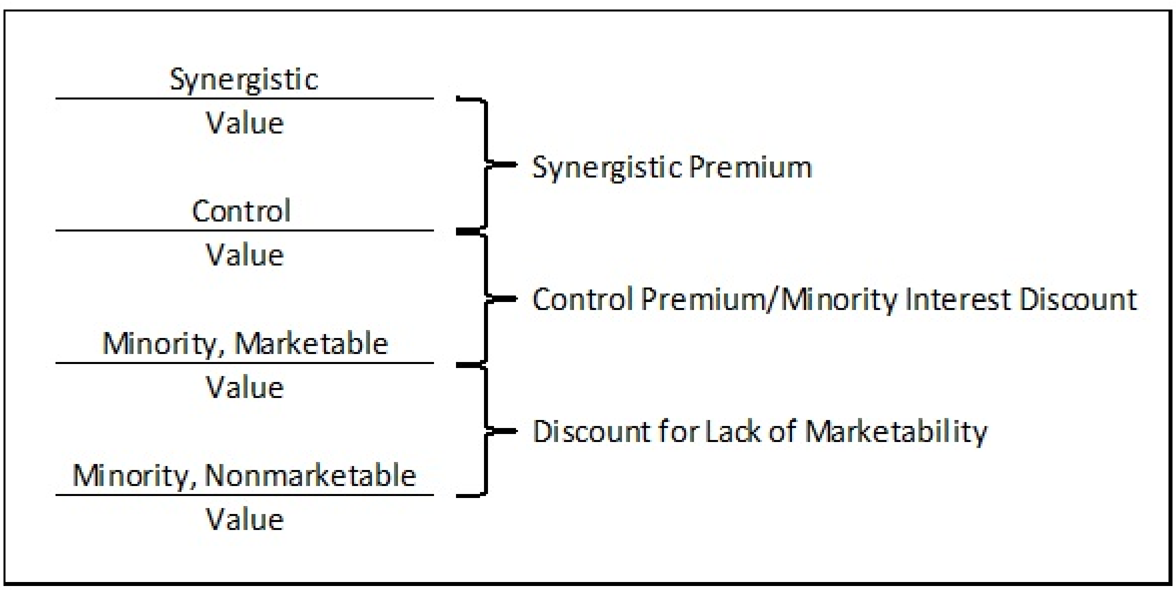
Following are three traditional levels of value:

1. Control value

2. Minority marketable value ("as if freely traded")

3. Minority non-marketable value

Exhibit 1



Synergistic (also known as "strategic" or "acquisition") value is a fourth level that reflects value to a particular buyer. Because gift and estate tax valuations are prepared using the standard of fair market value, which does not recognize synergies, this fourth level of value will not be addressed in this practice aid.

Prerogatives of Control

The benefits of control can be wide-ranging and add significant value to interests that have controlling ownership characteristics. The degree of control by majority owners can have an equally significant impact on the discounts applied to minority owners. For example, in situations in which controlling owners have the ability to divert more than their pro-rata share of the benefits of the business to themselves at the expense of the non-controlling owners, the minority interest would have a larger discount as compared to a similar minority interest in which the controlling interests did not have this capability. Other rights associated with majority ownership include, but are not limited to, the right to the following:

- Appoint or change operational management
- Elect directors
- Change the articles of incorporation or bylaws
- Borrow from, or lend to, the company at rates favorable to the controlling owner
- Negotiate agreements
- Merge with or buy another company
- Set policies
- Declare and pay dividends
- Determine future operational plans

Degree of Control

If an ownership interest has the characteristics of control (that is, it can make decisions that impact the company's operations, management, leadership, or direction) then it is appropriate, in fact, necessary, to consider these characteristics when determining the fair market value of the interest. In most cases, the ownership interests are likely to have a greater fair market value than they would if those features did not exist because the future benefit stream is expected to be larger. Between the two levels of control (all or none), a continuum exists, reflecting factors that can enhance or diminish control and consequently, increase or decrease the fair market value of an ownership interest. Frequently, the terms *non-controlling interest* and *minority interest* are used interchangeably to describe an ownership interest; however, this is not always an accurate description. For example, cases in which a 20 percent interest may be a minority interest and a non-controlling interest, a 50 percent interest may also be non-controlling but would have the ability to exert more influence than the 20 percent owner (although legally a minority interest in simple majority jurisdictions). In some instances, the difference could be viewed as significant enough to be considered a controlling interest. Therefore, it is critical the valuation analyst carefully consider all the characteristics of the ownership interest.

Determining the amount of control specific to an ownership interest is not always straightforward. State statutes, the company's articles of formation, bylaws and agreements, as well as the overall ownership distribution of the company must be considered individually as well as collectively. [fn 1] An overview of common ownership structures is discussed in the following text.

100 percent unilateral control—When an owner owns 100 percent of a company's equity, that individual can make decisions without regard to majority or supermajority requirements and does not have to be concerned with non-controlling owner rights.

Less than 100 percent, but more than a supermajority—In some states, more than a simple majority is required for major actions such as a merger, sale of the assets, or liquidation of the company. If an owner's ownership percentage exceeds the statutory requirements of his or her jurisdiction, the owner would have to consider the rights of the other owners, but would not be subject to having actions blocked.

Less than a supermajority, but more than 50 percent—An owner with more than 50 percent of the vote may have significant control over the business but may also be required to obtain approval from other owners for certain actions that require a supermajority.

A 50-percent ownership—A 50-percent interest generally represents neither a controlling ownership position nor a non-controlling ownership position. The holder of a 50-percent ownership interest is likely to have significant influence over the company (and other shareholders) and may be able to initiate or prevent certain actions within a company, but usually must obtain votes from other owners to conduct more significant transactions.

Less than 50 percent but the largest voting block—Similar to the 50-percent ownership described previously, if an owner owns less than 50 percent of a company, but that individual has the largest voting block of stock, the owner would likely have significant influence over the company. Of course, depending on how much less than 50 percent is owned, the shareholder may require more minority shareholder consensus to initiate or prevent any company change. The distribution of the other shares will determine the relative ease or difficulty of getting the necessary votes.

Less than 50 percent but in a "swing vote" position—An owner is said to be in a swing vote position when the interest he or she owns is less than 50 percent of a company's equity, but sufficiently large enough that other minority owners would seek to unite their votes. Depending on the distribution of the company's ownership, a swing vote position can yield significant influence over the company because this interest's vote may be required to break a deadlock.

Less than 50 percent and not in a swing vote position—This is the least influential position for an owner to be in. The vote of such an owner has little, if any, influence on its own and the block is not large enough for the owner to be courted as a swing vote. This owner is essentially a passive investor.

The process of determining the level of ownership and the degree of influence that may or may not be associated with the ownership interest can be complex, especially given the varying degrees of ownership interests and diverse state and local laws that affect corporate structure and governance. Therefore,

[fn 1] ***N.B.***, for the purposes of this discussion, the term *company* is meant to encompass all forms of privately held entities, such as C corporations, S corporations, partnerships, and so on.

in order to support a lack of control discount or control premium in a valuation report, the valuation analyst must obtain a thorough understanding of the entity's business and structure, articles of formation, regulatory environment, voting rights, and any other relevant information that will provide insight into how the owners run their business, as well as the external influences that could impact those decisions. The considerations discussed here are not meant to be all inclusive. Each valuation engagement will present unique facts and circumstances; therefore, it is up to the valuation analyst to assess each engagement independently.

Once the degree of control is determined, the valuation analyst will be tasked with placing a value on that level of control.

Control Value

As noted previously, the premium or discount applied to an ownership interest is based on the degree of control (or lack thereof) an owner has over the direction and management of the company. Control should ultimately be viewed as a proxy for future cash flows that an owner expects to receive over the term of his or her investment or ownership (or both). One generally accepted approach that valuation analysts use to determine the amount of a premium or discount is to initially value the ownership interest as if were a marketable minority interest (see exhibit 1). From this point, the valuation analyst would consider what impact the relevant control features would have on the baseline ownership value (for example, cash flow considerations, influence on business decisions, and so on) and adjust upwards accordingly.[fn 2]

In circumstances when ownership interests are initially valued as a control value (for example, includes control premiums, usually a pro-rata share of total equity value), it may be necessary for the valuation analyst to reduce the value of an interest that does not have comparable privileges. This would be done through the use of a minority interest discount and would result in an ownership interest valued as a marketable minority interest.[fn 3]

Non-Controlling Value

Ownership interests not large enough to control operations or make other decisions that affect the company both operationally and legally are generally considered non-controlling interests. A non-controlling interest is typically worth less than a controlling interest due to the diminished rights and ultimately a reduced interest in future benefit streams. The adjustment to reflect this decrease in value is known as a *minority interest discount* or *discount for lack of control*.

A minority interest discount is calculated as the inverse of a control premium. For example, if the minority value of a stock is $1 per share and an acquirer pays $1.30 per share to buy control, the acquirer has paid a 30-percent premium over the minority price. This 30-percent premium converts to a 23-percent minority interest discount as follows.

[fn 2] There are a number of publications and studies available that can assist in valuing a control premium. One highly regarded publication that is updated quarterly is FactSet Mergerstat's *Control Premium Study*. Refer to the end of this chapter for other publications.

[fn 3] Similar to control premiums, a number of studies and papers exist on how to value minority interest discounts. Valuation analysts may also determine that it is appropriate to take the inverse of a control premium for a particular privilege and apply it as a discount.

Exhibit 2

$$1 - \left[\frac{1}{1 + \text{control premium}} \right] = \text{Discount for Lack of Control}$$

1 - (1/1.3) = 1 - .77 = 23 percent discount for lack of control

To adjust the $1.30 control value to a non-controlling-marketable value see the following:

Control Value	$1.30
Discount for Lack of Control: 23%	(.30)
Non-Controlling Value	$1.00

Income Approach

There are several valuations methods available within the income approach. Regardless of the specific method chosen by the valuation analyst, applying the income approach requires the valuation analyst to consider the economic benefits of ownership and the cost of capital that will be applied to those benefits.

The most significant component in determining the "control versus non-control" decision is whether the anticipated or future benefit stream associated with the rights acquired includes the rights that permit the changes that a controlling owner could make to enhance value of the benefit stream. If the benefit stream includes no such rights, the conclusion would likely be that the acquired interest is a minority, or non-controlling interest. For example, a minority benefit stream may be negatively impacted by excess compensation paid to the controlling owner or payments made to parties or entities related to the controlling owner. These payments would drive down the ultimate economic benefits available to the minority owner and therefore the value of the minority interest.

Asset Approach

When applying the asset approach to value a business interest, the initial value indication will be at a control level of value because it assumes that the owner of the subject interest has the ability to sell or liquidate the company. When using the asset approach to value a non-controlling interest, a DLOC is usually required because the non-controlling interest does not have the liquidation rights inherent in a controlling interest.

The challenge facing a valuation analyst when using the asset approach to value a non-controlling interest is determining the magnitude of the discount for lack of control.

Market Approach

The market approach consists of two methods known as (1) the merger and acquisition method, and (2) the guideline public company method. Both methods require significant professional judgment and, as a result, well thought-out and documented analyses.

The merger and acquisitions method arrives at a value based on the principal that an owner of a significant (or entire) interest in a company can be determined through the comparison of transactions between companies with comparable businesses or business models. Of course, because transactions of this nature require owners to have controlling interests, this must be factored into the valuation engagement and adjusted accordingly if comparable features are not part of the ownership interest being valued. When using transaction data, the valuation analyst must also consider if the transaction represents an acquisition by a strategic buyer (adding a premium on top of a controlling interest value that may need adjustment to more closely reflect fair market value; see exhibit 1). This is an assessment based on facts and circumstances.

In contrast, the guideline public company method presumes a minority interest. This assumption is built on the fact that public company multiples are based on the pricing of minority interests traded on the public markets. Over time, practitioners have increasingly come to accept that the use of public multiples is no different than the use of a cost of equity based on observations from the public markets. For example, if the valuation analyst determines that a 20 percent cost of equity is correct, he or she would use that cost of equity to value either a minority interest or a controlling interest. The difference in the two valuations would be the benefit stream to which the cost of equity is applied. Because the multiples observed in the public markets come from the same data that provide the equity rates of return, the same could be said of the use of those multiples. The level of value conclusion is based on the benefit stream rather than the fact that the multiple comes from minority interests.

Other Factors to Consider

Possessing control of a company does not necessarily give the control owner the right to take actions at the expense of other owners. The controlling owner may have a fiduciary duty to the other owners that requires the company be managed to benefit all owners equally. For example, in cases where the controlling owner is clearly receiving value at the expense of the non-controlling owners, the non-controlling owners could take legal action to regain their share. In many states, minority owners can sue to dissolve the corporation.

Before considering applying a control premium or a discount for lack of control, the valuation analyst must always be certain where in the levels of value chart the current conclusion sits. An engagement may include several valuation methods which yield conclusions at different levels of value. A discount or premium suitable to one method may not be suitable to all.

Empirical Data

Regardless of the approach used for the engagement, the valuation analyst will most likely need to refer to external resources to assist in quantifying control premium and discount adjustments. There are several well-established services that provide current information on valuation adjustments; however, the valuation analyst must understand the differences between the resources and how best to adjust the valuation report accordingly.

Two of the more common sources of control premium data include *Factset Mergerstat Review* and Factset Mergerstat/BVR Control Premium Study.

Factset Mergerstat Review is a print book that is published annually and focuses on aggregate averages and trends. *Factset Mergerstat Review* includes online access to the *Factset Mergerstat Review Monthly Review*, which provides information on the latest M&A deals, news, and trends.

The Factset Mergerstat/BVR Control Premium Study, an online searchable database, provides more in-depth data on individual transactions. The Control Premium Study data is available online, allowing a detailed analysis of the transactions, thereby allowing the appraiser to develop a list of specific transactions more relevant to the company being valued. To the extent the data is available, the information can be analyzed by SIC code, size, industry, or other selected criteria.

One item to note is the difference between the ways in which the two studies treat transactions that occurred below their pre-merger public market trading prices—that is, those that reflected a "negative premium." The Factset Mergerstat/BVR Control Premium Study allows for the inclusion of negative premiums while the *Factset Mergerstat Review* excludes negative premiums when calculating average and median premiums.

Another difference between the two resources is the pre-acquisition announcement price used in their calculations. The Control Premium Study calculates the control premium using prices from five different dates prior to the acquisition and also uses a stock price it believes is unaffected by news of the acquisition transaction. *Mergerstat Review* uses a price five days before the transaction announcement.

Conclusion

Considerations regarding control will likely be part of every valuation engagement and resulting report. Therefore, it is critical that the valuation analyst know how to identify, calculate, and incorporate control premiums and lack of control discounts on each engagement. The ramifications to the client and ultimately the valuation analyst for not preparing a well thought-out and supportable valuation could result in added time, expense, and frustration for all parties.

Chapter 7

Discount for Lack of Marketability

Marketability

Marketability is defined in the International Glossary of Business Valuation Terms as "the ability to quickly convert property to cash at minimal cost." Marketability, as defined, is a continuum. Marketable assets that are actively traded in a secondary market with quoted prices and minimum spread between bid and ask prices are said to be highly liquid. Examples of actively traded, liquid markets are most securities traded on any of the major exchanges, the commodities markets, and the U.S. Treasury markets. It is worth noting that liquidity and marketability are not necessarily the same. In order for an asset to be considered liquid, it must be marketable. However, an asset that is marketable may not necessarily be liquid.

Examples of marketable assets that may not be considered liquid include closely held stock, partnership interests, and securities issued under restrictive SEC guidelines (for example, Rule 144). The impact of this lack of liquidity often results in a discount in price to the purchaser as an incentive for the investment of capital. Without such a discount, all other things being equal, an investor is less likely to invest in an asset that may not be readily convertible to cash when a comparable asset has that liquidity feature. In the valuation community, this discount is known as the discount for lack of marketability (DLOM), and it is a common issue for valuation analysts when performing a valuation engagement for estate and gift tax purposes.

Historical Analysis of the Discount for Lack of Marketability

For decades, both academics and the SEC performed studies to try to estimate the magnitude of price concessions in transactions involving matched pairs of securities which had no differences other than the freedom to trade in an established market versus a restriction upon that freedom. These studies fell into two general classes: (1) restricted stock studies, and (2) pre-initial public offering (IPO) studies.

Restricted Stock Studies

Restricted stock studies compared the price of a freely traded share of the stock of a publicly traded company to the price at which a private placement of the same security was made on the same day. The security in the private placement is restricted from trading for a specific period of time (originally two years and now six months) under the provisions of SEC Rule 144 in effect at the time.

Within the restricted stock study category, there was a variety of studies performed from 1966 to 2008. These studies found a range of discounts between 13 percent and 45 percent for transactions involving stock that is identical in all respects to the freely traded stock of a public company, except that it is restricted from trading on the open market for a certain period of time.

Pre-IPO Studies

The pre-IPO studies compared the prices observed in private transactions in a company's stock in the months preceding the IPO to the prices observed in subsequent public offerings of the same stock.

The pre-IPO studies indicated a higher average discount than the results suggested by the restricted stock studies. This difference was attributed to the fact that the pre-public offering transactions occurred when there was not yet any established secondary market for the subject stock. This is similar to an interest in a closely held company, which has, at best, a limited secondary market. Unlike the companies in the pre-IPO studies, closely held companies generally have no near-term public offering or other equivalent liquidity event on the horizon. This would indicate a higher discount for an interest in a closely held company than those observed in these studies.

Many basic business valuation texts contain detailed information about these studies. [fn 1] Readers should refer to these texts for that detail and background.

In addition, there were several studies prepared and published during the period of the progressive reduction of the SEC Rule 144 holding period. These include two studies prepared by Columbia Financial Advisors immediately before and after the reduction of the two-year term to one year, [fn 2] two studies prepared by Trugman Valuation Associates, [fn 3] and one prepared by Stout, Risius, Ross. [fn 4] A sequential review of the studies as the SEC Rule 144 restriction period dropped from two years to one year in 1997 and to six months (on February 15, 2008) shows a general decline in the level of observed discounts, from levels in excess of 30 percent when the two-year holding period was in effect, to an average of 10.9 percent and median of 9.3 percent for the Stout, Risius, Ross study covering the years 2005–2010.

Each study noted had previously tested a population that had attained (or, in the case of the pre-IPO studies, would soon attain) access to the public markets.

These studies also shared the following attributes:

- Each company had already grown, or was expected to grow, to sufficient size to generate interest in ownership from the public.

- Each company had been, or was expected to become, profitable, with the benefits of those profits being distributed fairly among various stakeholders based exclusively on their respective legal claims.

[fn 1] Commonly referenced valuation texts are as follows: (1) Shannon P. Pratt and Alina Niculta, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies—Fifth Edition* (New York: McGraw-Hill, 2008) pages 415–440; (2) James Hitchner, *Financial Valuation: Application and Models—Third Edition* (Hoboken, NJ: John Wiley & Sons, 2011) pages 411–415; (3) Gary R. Trugman, *Understanding Business Valuation, Fourth Edition* (New York: American Institute of Certified Public Accountants, 2008) pages 415–423; and (4) Z. Christopher Mercer, *Quantifying Marketability Discounts* (Memphis: Peabody Publishing, LP, 1997) pages 37–91; 345–364.

[fn 2] Kathryn F. Aschwald, "Restricted Stock Discounts Decline as a Result of 1-Year Holding Period," *Shannon Pratt's Business Valuation Update* (May 2001) quoted in Pratt, Shannon, P., *Business Valuation Discounts and Premiums* (New York: John Wiley & Sons, 2001) page 109.

[fn 3] William Harris, "Trugman Valuation Associates, Inc. (TVA) Restricted Stock Study," *Business Valuation Review*, Vol. 28, No.3, pages 128–139 and Vol. 30, No.4, pages 132–139.

[fn 4] Aaron M. Stumpf, Robert Martinez, and Christopher T. Stallman, "The Stout Risius Ross Restricted Stock Study: A Recent Examination of Private Placement Transactions from September 2005 through May 2010," *Business Valuation Review*, Vol. 30, No. 1, pages 7–19.

- Each company had audited financial statements, a board of directors with independent members and an audit committee, and management subject to review and direction by that board.

Several widely available commercial products have facilitated the analyses of restricted stock and pre-IPO transactions. These tools generally provide the user with multiple search criteria, enabling the valuation analyst to drill down through multiple data fields to identify potentially relevant transactions or characteristics.

The Mandelbaum Factors

Perhaps the most widely cited authoritative guidance for consideration of liquidity impairment is Judge David Laro's decision in the 1995 Tax Court case of *Mandelbaum v. Commissioner.* [fn 5] While the decision does not distinguish between marketability and liquidity, it does lay out 10 factors (each subjective to some degree) to analyze and quantify the degree to which a security should be discounted from its theoretical fully liquid (and marketable) value. The court used restricted stock and pre-IPO studies as a starting point and compared the subject company to the studies based on the following factors:

1. Private versus public sales of the stock
2. Financial statement analysis
3. Company's dividend policy
4. Company's nature, history, position in the industry, and economic outlook
5. Company's management
6. Degree of control transferred with block of shares to be valued
7. Restrictions on transferability of stock
8. Holding period for the stock
9. Company's redemption policy
10. Costs associated with affecting a public offering

Note that there is an inherent overlap, particularly in factors 1, 3, and 4, with core considerations in the development of a discount rate. Valuation analysts should be aware that because of this overlap, there exists the potential for double-counting an area of risk in developing an opinion of value.

While these factors are, to some degree, subjective, many were analyzed in the earlier studies to develop the magnitude and direction of their influence on observed discounts. The Mandelbaum case analysis laid out by Judge Laro is a synthesis of the conclusions of the earlier studies. The *Mandelbaum* case remains a core analytic tool notwithstanding either its age or its lack of discrimination between marketability and liquidity.

[fn 5] *Mandelbaum v. Commissioner, T.C. Memo 1995 -255, June 12, 1995.*

It is important to note that the Mandelbaum case analysis was written prior to the reduction of the Rule 144 holding period to less than two years. Studies subsequent to those reductions (Columbia, Trugman, and Stout, Risius, Ross) have all shown material declines in median and mean observed discounts from the 35 percent to 45 percent serving as the *Mandelbaum* benchmark, emphasizing the critical nature of the term of the trading impairment on the magnitude of the discount. Furthermore, the dispersion of the results of most of the larger studies suggests that multiple factors, as identified in *Mandelbaum*, affect the observed discount. [fn 6]

Quantitative Tools for Estimating a DLOM

In 1997, Chris Mercer published *Quantifying Marketability Discounts.* In the book, he introduced the quantitative marketability discount method (QMDM). The QMDM expanded upon the previous work of John C. Harper and J. Peter Lindquist, which suggested that a discount for lack of marketability could be calculated using the relationship between the value of a company based on enterprise-level cash flows versus shareholder-level cash flows.

Valuation analysts also use various option-based models to estimate DLOMs. The most commonly used model is a simple Black-Scholes option pricing model used to estimate the value of European-style options. The result of the option model calculation is the price that the theoretical holder of the security would pay to buy protection against a price decline during the term of an anticipated holding period. [fn 7]

Other models have come into common use since Black-Scholes. One of the most often-referenced is the Longstaff Upper Bound Lookback put option model. Published in 1995, [fn 8] the Longstaff model assumes the holder of the option has perfect hindsight and therefore would exercise the option at the optimal point during the term of the option. The value of a look-back option is greater than a regular option, so it will cost more leading to a higher DLOM. For a hypothetical investor, the Longstaff model represents a logical upper bound to the DLOM.

Following Longstaff, an Asian look-back put option model (Finnerty model) developed by Professor John Finnerty of Fordham University [fn 9] has had significant support, especially from audit professionals who focus on compliance with FASB *Accounting Standards Codification* (ASC) Topic 718, *Stock Based Compensation*. The Finnerty model produces a value based upon the average underlying value during the term of the option. Like the Longstaff model, the Finnerty model can produce indicated discounts in

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[fn 6] A complementary model of subjective factors targeted at holding companies (such as Family Limited Partnerships or LLCs which operate as holding companies) was developed by Charles Elliot, CFA, ASA, and published in his article "Valuing Family Limited Partnerships." That article is quoted at length in Robert Reilly's and Robert Schweihs' *The Handbook of Advanced Business Valuation*, (New York: McGraw Hill, 2000,) pages 155–173.

[fn 7] The European Option is exercisable only at the end of the option life. The original 1993 publication by David Chaffe was based upon the European Option. David B. Chaffe, III "Option Pricing as a Proxy for Discount for Lack of Marketability in Private Company Valuations," *Business Valuation Review* (December 1993).

[fn 8] Francis A. Longstaff "How Much Can Marketability Affect Security Values?" *Journal of Finance*, December 1995, Vol. 50 No. 5, pages 1767–1774.

[fn 9] John Finnerty, "The Impact of Transfer Restrictions on Stock Prices" (October 2002). AFA 2003 Washington, D.C. Meetings. Paper critiqued by Stillian Ghaiderov of Grant Thornton in September 2009 in "Analysis and Critique of Average Strike Put Option Marketability Discount Model." Finnerty model modified in response as of October 2009.

excess of 100 percent. However, while such indications occur using Longstaff with relatively short holding periods and lower volatilities, a protracted holding period and high volatility are requisite inputs when using the Finnerty model.

Finally, Ronald Seaman has published numerous articles on the use of long-term equity anticipation securities (LEAPS) as an option-based technique for estimating liquidity discounts. LEAPS are publicly listed and traded options, usually on stocks with larger capitalizations. LEAPS, when issued, can have terms of as long as three years. The quoted price of the LEAPS in relationship to price of the underlying security produces an indicated discount. Furthermore, using the price of the LEAPS and other data relating to the underlying security and the option term, an analyst can use a Black-Scholes variant to determine the implied (forward) volatility for the stock over the life of the LEAPS and use that volatility in conjunction with other elements of the overall analysis. To the extent that the holding period for the privately traded security is expected to materially exceed the remaining life of the LEAPS, the LEAPS indications would typically provide a lower bound to the discount unless it can be demonstrated that the public companies would be likely to be far more volatile that the expected volatility of the privately held security. [fn 10]

Conclusion

Notwithstanding the variety of approaches available for estimating a discount for lack of marketability, there is a remarkable and logical consistency throughout all of the analytical elements:

- The longer the period of restriction, the greater the discount.
- The greater the risk (whether measured by profitability, volatility, market capitalization, or any other measure), the greater the discount.

The valuation analyst will need to decide based on the facts and circumstances of his or her engagement which approach is most suitable and which will produce the strongest case for the reported conclusion of value.

[fn 10] In 2009, the IRS issued "Discount for Lack of Marketability—Job Aid for IRS Valuation Professionals" to provide non-authoritative guidance on methodologies and considerations when applying discounts for lack of marketability to assets. See www.irs.gov/Businesses/Valuation-of-Assets.

Chapter 8

Family Limited Partnerships and Limited Liability Companies

Introduction

A family limited partnership is a nontaxable entity that is created and governed by state statute and whose partners (both general and limited) and assignees consist mainly of family members. A limited partnership is created under and governed by the Revised Uniform Limited Partnership Act (RULPA) of the state in which it is formed. Though the states' RUPLAs are similar in many respects, each state's act contains different features (although some states' acts are the same).

A limited liability company has a different legal structure, with characteristics of a corporation and of a partnership, but the valuation issues resemble those of a family limited partnership. A limited liability company looks like a partnership or limited partnership in terms of internal structure and relationships between members, or members and managers, but with the additional characteristic of a liability shield from vicarious liability for members and managers.

This chapter refers to family limited partnerships and family limited liability companies as FLPs.

FLPs are particularly attractive as estate planning tools because through the creation of an FLP, the following information is true:

- It promotes the efficient and economic management of the assets and properties under one entity.
- Parents or grandparents have the ability to indirectly transfer interests in family owned assets but maintain the group of assets as a whole.
- Protection against creditors can be achieved at a high degree because a partner's creditor cannot legally gain access to the assets in the partnership.
- Assets can be kept in the family, which is an objective of many families. This can be achieved by placing restrictions on the transfer of partnership interests—especially in the event of divorce, bankruptcy, or death of a partner.
- Problems pertaining to undivided or fractionalized interests when a property is gifted to several individuals can be avoided. This can be especially important in the case of real estate.
- Advantages can arise through economies of scale and diversification when family owned assets are placed in a partnership.
- Partnership agreements can provide a great deal of flexibility; partnership agreements can also provide broad investment and business powers. These can be amended as the family's needs change, as long as all partners agree.
- Partnerships are pass-through entities and do not pay income taxes.

- Gifting or transferring an ownership interest in a limited partnership may be made at a lower value than that interest's pro rata share of net asset value. The reason for this is that a limited partnership interest is likely to be both non-controlling and non-marketable.

- FLPs can provide a vehicle for resolution of any disputes and avoid the expense and problems of litigation.

- FLPs can help promote the family's knowledge of and communication about the family assets.

Data Gathering

The following information should be obtained in order to perform the valuation and should be referenced in the report:

- Agreement of partnership (agreement) (or other type of business agreement depending upon the form of the entity), along with all amendments, as well as a copy of the certificate of limited partnership that has been filed with the state in which the partnership was created. The certificate is an important document because it gives notice of the formation of the limited partnership and the limited liability of the limited partners. Because different states have varying statutes, knowing the rules of the state in which the entity is formed provides the legal structure of the FLP in conjunction with the terms of the agreement.

- List of the assets that were initially contributed to the partnership, as well as documentation about any assets that were contributed after the formation of the FLP.

- Valuations of real estate and other assets held by the partnership as of the valuation date (for example, market values of marketable securities). If the partnership owns interests in other closely held businesses or partnerships, these interests must be separately appraised before the value of the LP interest can be determined. If the entity has any liabilities, these values should be provided as well.

- Financial statements or tax returns (or both) for the partnership for a reasonable number of years, or since inception. These documents will not exist for new partnerships.

- General partner's anticipated policies regarding distributions or a Section 754 election (or both).

- Information about if the FLP is ongoing, as well as a history of distributions (if any) made to partners.

- Information such as minutes of partners’ meetings or other documents, if they exist, may give the analyst some insight into the donor’s intent at the time the partnership formed.

Understanding the Agreement

The basic characteristics of the transferred interest in the FLP, combined with specific provisions in the agreement and state law, form the foundation for the valuation adjustments used in arriving at the fair market value of the transferred interest. A thorough understanding of the provisions of the agreement will help the valuation analyst define the subject interest and the rights associated with it.

Many of the issues that arise in appraising FLPs become legal interpretations of the agreement, rather than "pure" valuation issues. Although it is important that valuation analysts know and understand the issues, it is imperative that they leave the "lawyering" to the lawyers. If any doubt exists in the valuation analyst's mind regarding the nature of the assignment or the terms of the agreement, the client's attorney should be the one to explain it to the valuation analyst, not the other way around.

Some of the factors to be considered in determining appropriate valuation adjustments may come as a result of provisions in the agreement. Some of these provisions include the following:

- A provision (term-of-years provision) in the partnership agreement that the partnership shall continue to exist for a definite term of years, unless it is dissolved or liquidated prior to this date.
- No guarantee by the managing general partner or general partners of the return of any partner's capital contributions or any distributions of distributable cash (not even enough to cover the annual taxes of the partners).
- Approval rights of limited partners required for certain major decisions; otherwise limited partners and assignees are excluded from participation in management.
- How the election of new managing general partners is accomplished.
- A provision that distances the limited partners and assignees from the assets of the FLP.
- The right of the general partner(s) to determine whether cash will be distributed and at what amount.
- Capital call provision that obligates partners and assignees.
- Limitations on the voluntary and involuntary transferability of general partner, limited partner, and assignee interests.
- The presence of rights of first refusal.
- Whether the transferee of an interest is a partner or an assignee.
- Consent of all partners required for a transferee or assignee of an interest in the partnership to become a substituted limited partner.
- Whether the general partners are required to make an IRC Section 754 election.
- Limitations on the "right" of the general partner to withdraw from the partnership prior to the expiration of its stated term and a provision that, should the general partner exercise his or her power to withdraw early, his or her general partner interest shall become a limited partner interest and he or she may also be subject to damages for breach.
- Limitations on the right of a limited partner and assignee to withdraw from the partnership prior to the expiration of its stated term.
- Provisions for dissolution of the partnership mirroring state law.

Some factors that need to be considered but may not be found in the agreement include the following:

- Size of the interest
- Number of investors in the partnership
- Type of assets owned by the partnership
- Whether or not the assets of the partnership are well diversified
- Current and historical amount of cash actually distributed to partners and assignees
- Underlying cash flow coverage of yearly distributions made to partners and assignees
- The "default rules" under state law
- The reputation, integrity, and perceived competence of the partnership management and general partner(s)
- Amount of financial leverage inherent in the partnership's capital structure
- Caliber of the information flow from the partnership and the general partner(s)
- Universe of interested buyers

The assets held by an FLP typically include investments such as cash, stocks, bonds, private equity investments, hedge fund interests, and real estate. In order to maximize the value of creating the FLP, the assets placed in the FLP should be expected to appreciate. Personal assets, especially a personal residence, should not be placed in an FLP, as doing so could jeopardize the status of the FLP because of the requirement that the FLP have a legitimate business purpose. In addition, placing a personal residence in an FLP could deny the taxpayer certain advantages upon the sale of the property. Also, the creator(s) should not transfer all personal assets to an FLP; the creator(s) should maintain enough assets to pay personal bills without relying on the FLP for distributions.

Valuation Considerations

Valuation of an interest in an FLP requires much of the same analysis as the valuation of an interest in any other closely held company. Each of the three basic valuation approaches must be considered. The approach that is relied upon most heavily will depend on the circumstances of the subject interest.

Historically, many valuation analysts have utilized a valuation method under the asset-based approach to value an FLP. Although less common, a valuation method under the income or market approaches may also be used.

Under the asset-based approach, the net asset value (NAV) of an FLP is generally considered the amount for which a controlling ownership interest could liquidate the underlying assets and liabilities (although note that the valuation of these assets does not include the costs to sell these assets). In other words, the NAV is the sum of the total market value of an FLP's assets minus its liabilities. In order to determine the company's NAV, the analyst typically starts with the reported book values of assets and liabilities, as of the valuation date, and adjusts them to their current fair market values. Establishing the fair market value of cash or investment interests is usually done by referencing bank and investment account statements. The value of publicly traded investments can usually be determined as of a precise date. The value of less liquid investments may not be determined as easily. The value of some investment funds may only provide valuations quarterly. FLPs that hold real estate or equipment may require appraisals by specialists in those areas.

Under the income approach, the analyst can consider discounting the expected future cash flows for each asset held by the FLP. For example, the current market value of an equity portfolio of $5 million with a 10-percent expected return would result in $500,000 of income. The valuation analyst might assume that the future cash flows will include the distribution of all interest, dividends, and capital appreciation that will accrue to the benefit of the interest owner even if not distributed currently. Alternatively, if using only interest and dividends in the net cash flow forecast, growth in the equity portfolio for the undistributed capital appreciation should be factored in, with an assumption of a future liquidating event. The appropriate rates of return can be derived using alternative rates of return from publicly traded stocks, bonds, real estate investment trusts, and limited partnership interests.

Under the market approach, market-derived price/NAV (P/NAV) multiples can be used to directly determine the non-controlling, marketable value of an FLP interest. Although not frequently used to directly value an interest, these multiples can be used to determine a discount for lack of control as discussed in the following information.

Valuation Adjustments

Depending on the valuation methods used, discounts for lack of control and marketability will usually be appropriate.

Once the value of the FLP has been determined (especially when the asset-based approach has been applied), the valuation analyst will then apply an appropriate discount for lack of control (DLOC) to convert a controlling interest value into a minority interest value.

The most common method of determining this discount is by application of a market-derived P/NAV ratio. This ratio captures the return on investment that a minority owner would expect. Because the increased risk related to lack of control requires a higher rate of return, an investor discounts the price of the minority interest to a level sufficient to produce a return that is commensurate with the risk of the investment.

Data from closed-end mutual funds or publicly registered real estate partnerships can provide P/NAV ratios. The discounts reported in this data reflect the circumstances that affect the risk and reward (future benefits) of the interests included in the data. Qualitative and quantitative comparisons should be made between the data used to derive discounts and the subject interest.

The discount for lack of marketability appropriate for an FLP interest is determined using much the same analysis that an analyst would use for any other interest in a closely held entity. An additional important factor when considering the DLOM to apply to an FLP interest is that there may be some lack of marketability included in the market data used earlier in the analysis. Publicly registered real estate partnerships are traded on a secondary market which is not nearly as liquid as the market for publicly traded stocks. Analysts should consider the likelihood that the reported P/NAV ratios also include a small discount for the time it would take to convert these interests to cash.

When discounts are applied to an FLP valuation, valuation analysts should carefully document and be able to support the magnitude of the discount taken for the simple fact that this is an area that the IRS scrutinizes. Although the IRS is concerned with excessive discounts, some case law has centered on the issue of whether the partnership "truly" exists. The IRS has raised this issue by either attacking the reason for the formation of the partnership or by raising Chapter 14 issues, specifically Section 2703 and Section 2704. The IRS has also had success with Section 2036 arguments. If the IRS can make a successful argument on any of these issues, then the FLP could be seen as an invalid entity, and the gifts could become gifts of the underlying assets directly, rather than partnership interests (in other words, no discounts) or under Section 2036, the underlying assets could be taxed as part of the estate, rather than as an FLP interest.

IRC Section 2036—Transfers with Retained Life Estate

FLPs were designed to allow the transfer of assets from a family member into a partnership which in turn would prevent those assets from being included in the family member's estate upon death. The valuation analyst must use caution whenever dealing with FLPs because if these are not set up properly, assets transferred to the FLP with the intent of removing the assets from an estate could be clawed back into the estate and more than likely result in unintended and unfavorable tax consequences.

When FLPs were first used by taxpayers as an estate planning strategy, the IRS did not agree with the approach (for obvious reasons) and tried a number of ways to invalidate FLPs, including, but not limited to, no business purpose, the agreement being more restrictive than state law, and failure to follow the formalities of setting up the structure and transferring assets. For the most part, these arguments failed in the courts.

The IRS has achieved (and continues to achieve) success in challenging FLPs through the use IRC Section 2036. [fn 1] The IRS and the courts thoroughly scrutinize the nature of the transactions conducted by the FLP and its partners to assess whether any asset transfers to and from the FLP are transfers that allow the grantor to retain a life estate interest (which are includable in gross estate). Due to the diversity of facts and circumstances surrounding how and why FLPs are set up, there are numerous decisions both for and against the taxpayer. Therefore, while not directly a valuation issue, a valuation analyst who must evaluate (or possibly even set up) an FLP would be prudent to consult with a subject matter expert to help ensure the FLP can withstand the challenge of the IRS and the courts if necessary. As previously noted, failure to do so could result in a significantly larger gross estate, as well as the possibility of a significantly larger federal (and maybe state) estate tax bill.

Step Transactions and Indirect Gifts on Formation

Valuation analysts should take similar precautions when it comes to understanding when and how an FLP is funded. This is especially important when the FLP transfers assets to the beneficiaries in a contemporaneous transaction to the funding or shortly thereafter. The IRS has prevailed in a number of cases where FLPs were funded by the grantor and then, in close proximity to receiving the assets, distributed interests in the FLP to beneficiaries. By utilizing the step transaction doctrine, the IRS succeeded in diminishing or eliminating gift tax valuation discounts on minority positions of FLPs on the premise that

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[fn 1] The first time the IRS utilized and prevailed using IRC Section 2036 as a way to challenge the FLP structure was in 2003 with the Tax Court's decision in *Estate of Albert Strangi, et al. v. Commissioner*, T.C. Memo 2003-145.

the asset transfer to the FLP was merely an indirect gift to the beneficiary, not a means of funding the FLP. In short, where assets are transferred strictly for the purpose of tax avoidance, the Tax Court may eliminate the middle steps (setting up FLP and then distributing assets to beneficiaries) and simply look at the end results as if the middle steps never occurred. This allows the court to prevent form over substance transactions from achieving tax consequences not intended by the tax laws.

That is not to suggest that all transfers of interests in FLPs to beneficiaries shortly after receiving assets will result in a diminished or eliminated valuation discount. An example of where taxpayers prevailed can be seen in *Thomas H. Holman, Jr. v. Commissioner*, 130 T.C. No. 12. In this case, the taxpayers created and funded an FLP on November 2, 1999, and within several days made gifts of stock to trusts for their children. The IRS claimed that because the transfers were made so quickly after the funding, they were indirect gifts. In this case, however, the court ruled that there was a risk of loss of value in between the date of the funding and the date of the gift and ruled in favor of the taxpayers.

Conclusion

As FLPs have grown in popularity, they have drawn more and more scrutiny from the IRS. The IRS frequently uses the valuation of FLP interests as its point of attack. Therefore, it is crucial that the correct valuation methods are used to value FLP interests and that the methods are properly applied.

Chapter 9

Miscellaneous Issues

Following is a brief discussion of some less common issues that may come up in valuations for estate and gift tax purposes. The valuation analyst should research these topics more fully as needed as this discussion is not intended to be all inclusive.

Built-in Gains Discount

A built-in gains discount is a discount or reduction in the value of an interest in an entity, typically a C corporation, which has a built-in capital gains tax liability. A buyer of a C corporation interest would typically discount the price paid for an equity position to account for the fact that upon liquidation, certain appreciated assets the entity holds would be subject to capital gains taxes. The valuation analyst can help develop an appropriate discount that would be applied to the stock's purchase price to offset the impact of capital gains taxes paid on the appreciated assets at some future liquidation event.

Prior to the Tax Reform Act of 1986 (TRA), taxpayers were allowed an election to treat the acquisition of the equity in a C corporation as if it was an acquisition of the assets of the C corporation. The asset-acquisition tax treatment allowed the C corporation buyer to depreciate the fair market value (that is, the "stepped-up basis") of the acquired assets. In addition, the asset-acquisition tax treatment allowed the seller to recognize the gain on the sale of the C corporation assets at the amount of the purchase price for the transaction.

This federal income tax treatment was referred to as the General Utilities doctrine, named after a landmark tax case and allowed the selling shareholders to avoid the payment of double taxation on the "deemed" liquidation of the C corporation assets. With the passage of the TRA, this tax treatment became obsolete and instead of the step-up in basis, the income tax bases of the acquired assets are carried forward and no step-ups are recognized by the buyer of the company.

When an asset with unrecognized appreciation is held by a C corporation, a built-in gain (BIG) tax obligation exists which is not paid by the C corporation until that asset is sold. A BIG tax obligation can exist whether the subject C corporation is either an operating company, an investment, or a holding company and can be a material variable in determining fair market value.

In federal estate tax matters, the BIG tax issue has been and continues to be the subject of litigation. Federal courts have allowed a valuation adjustment to reflect the BIG tax obligation when determining the business value of a C corporation; however, some courts have limited the magnitude of valuation adjustments related to built-in gains tax liability.

In 1998, the Tax Court recognized the valuation implications of the liability represented by the built-in capital gains tax associated with appreciated capital assets held in a C corporation. The *Estate of Davis* was the first judicial decision to recognize the BIG tax valuation impact following the repeal of the General Utilities doctrine. [fn 1] In the Davis case, the gift tax value of 2 25-share blocks of stock out of 97 total shares of a C corporation was at issue.

The taxpayer's two valuation analysts and the IRS valuation analyst testified that a valuation adjustment was warranted. The dispute, however, was over the appropriate amount of the valuation adjustment.

The Tax Court found that the full amount of the built-in tax liability of $26.7 million should not be taken as a valuation discount when there was no evidence that the subject C corporation planned to liquidate or sell any of its appreciated assets. The Tax Court concluded that it was appropriate to include a BIG tax valuation discount of $9 million as a part of the DLOM. Shortly after the Davis decision, in *Eisenberg v. Commissioner*, the Second Circuit reversed a memorandum decision of the Tax Court. The appeals court found that the Tax Court erred in not considering the BIG tax liability as a valuation adjustment, and the Second Circuit remanded the case back to the Tax Court to decide on the amount of the liability-related valuation adjustment. [fn 2] The IRS has acquiesced to the Eisenberg decision "to the extent that it holds that there is no legal prohibition against such a discount." [fn 3]

In 1999, the Tax Court again allowed a valuation discount related to the BIG tax liability. [fn 4] In the *Estate of Jameson*, the decedent owned an interest in a closely held corporation that held timberland as its primary asset. In its memorandum decision, the Tax Court stated the following:

> We may allow the application of a built-in capital gains discount if we believe that a hypothetical buyer would have taken into account the tax consequences of built-in capital gains when arriving at the amount he would be willing to pay for decedent's Johnco stock. Because Johnco's timber assets are the principal source of the built-in capital gains and, as discussed infra, are subject to special tax rules that make certain the recognition of the built-in capital gains over time, we think it is clear that a hypothetical buyer would take into account some measure of Johnco's built-in capital gains in valuing decedent's Johnco stock. [fn 5]

As the timber was cut and sold, recognition of the built-in gain was certain to occur. According to the Tax Court decision, a hypothetical willing buyer of the subject equity "would take into account Johnco's built-in capital gains, even if his plans were to hold the assets and cut the timber on a sustainable yield basis." However, the Tax Court limited the amount of the valuation discount to "an amount reflecting the rate at which they [the BIG taxes] will be recognized, measured as the net present value of the built-in capital gains tax liability that will be incurred over time as timber is cut."

The Fifth Circuit Court of Appeals reversed the Tax Court's decision in *Estate of Jameson.* The appeals court noted that the Tax Court denied "a full discount for the accrued capital gains liability" based upon internally inconsistent long range timber production assumptions. The Fifth Circuit Court remanded the

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[fn 1] *Estate of Davis v. Commissioner*, 110 T.C. 530 (1998).

[fn 2] *Eisenberg v. Commissioner*, 155 F.3d 50 (2d Cir. 1998).

[fn 3] AOD 1999 001.

[fn 4] *Estate of Jameson v. Commissioner*, 77 T.C.M. (CCH) 1383 (1999).

[fn 5] 77 T.C.M. at 1396.

case back to the Tax Court for a valuation analysis consistent with its opinion that the buyer would either lower the purchase price or sell the interest quickly and redeploy the proceeds elsewhere. [fn 6]

The following paragraphs summarize some other cases of interest in which the court found in favor of allowing discounts for the BIG tax liability.

In 2002, the Fifth Circuit decided in *Estate of Dunn* that, as a matter of law, the BIG tax liability should be considered as a dollar-for-dollar reduction when calculating the asset-based value. [fn 7]

In 2007, the Eleventh Circuit decided in *Estate of Jelke,* that the asset-based valuation approach contemplates the consummation of the sale of the subject asset, thereby triggering the BIG tax. The court agreed with and adopted the Fifth Circuit's dollar-for-dollar valuation discount procedure. [fn 8]

In 2009, the Tax Court decided in *Estate of Litchfield* to allow a BIG tax-related valuation discount based on the assumption that the assets would be sold over time. The Tax Court adopted the taxpayer's methodology of

- projecting holding periods and estimated sales dates for the corporation's assets,
- projecting asset appreciation to the estimated sales dates, and
- discounting the expected future BIG tax back to the valuation date. [fn 9]

In 2010, the Tax Court decided in *Estate of Jensen* that the BIG tax valuation discount was to be applied in a case where the primary assets of the C corporation were real estate and real property improvements. The Tax Court, assuming that the assets would be sold in the future, calculated the appreciated future value of the land and related improvements. The resulting estimated future tax payments (based on future value of the assets) were then discounted to a present value using a discount rate equal to the assumed appreciation rate of the assets. Ultimately, the Tax Court accepted the taxpayer's BIG discount because the Tax Court's analyses resulted in a BIG tax liability slightly greater than the taxpayer's. [fn 10]

In 2014, the Tax Court decided in *Estate of Richmond* [fn 11] that some discount for a built-in gains tax liability was appropriate for an interest in a corporation that held a portfolio of publicly traded securities. The court rejected a dollar-for-dollar discount as suggested by the estate's expert and also rejected the IRS expert's approach of embedding an additional 15 percent discount within the discount for lack of marketability. Ultimately, the court found that a potential investor would expect that the company's

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[fn 6] *Estate of Jameson v. Commissioner,* 267 F.3d 366 (5th Cir. 2001).

[fn 7] *Estate of Dunn v. Commissioner*, 301 F.3d 339 (5th Cir. 2002).

[fn 8] *Estate of Jelke v. Commissioner*, 507 F.3d 1317 (11th Cir. 2007).

[fn 9] *Estate of Litchfield v. Commissioner,* T.C. Memo. 2009-21 (January 29, 2009).

[fn 10] *Estate of Jensen v. Commissioner,* T.C. Memo 2010-182 (August 10, 2010).

[fn 11] *Estate of Helen P. Richmond, Amanda Zerbey v. Commissioner,* T.C. memo. 2014-26 (February 11, 2014).

portfolio would turn over during a 20- to 30-year period. As a result, the court held that the built-in gains discount should be calculated as the present value of paying off that liability in the future.

Tax-Affecting Pass-Through Entities

Up until the late 1990s, valuation analysts commonly incorporated the philosophy of tax affecting all entities at a 40-percent tax rate or at the median effective tax rate of the public company guideline group used in their analyses. This held true after normalizing the income statement of a C corporation and then tax affecting the adjusted pre-tax earnings. It also held true for pass-through entities such S corporations, partnerships, or LLCs.

In 1999, the *Gross vs. Commissioner* decision was handed down by the Tax Court (T.C. Memo 1999-254, affd. 272 F 3d 333 6th Cir. 2001), which concluded that S corporation shares are inherently more valuable than C corporation shares. This case, as well as other notable cases, led to the evolution of various theories and financial models in use today. While Tax Court challenges highlighted the difference between C corporations and pass-through entities, improved technology, wider access to data, and other market forces have helped evolve the sophistication of the valuation profession.

Some well-known authors who have developed models for valuing non-controlling interests in pass-through entities include the following:

- Chris Treharne
- Daniel Van Vleet
- Chris Mercer
- Roger Grabowski
- Nancy Fannon

These models take into consideration distributions, retained net income, holding periods, tax rates, additional discounts for minority and marketability, and the potential for a step-up in basis.

The theory on this topic continues to evolve. Some analysts now propose that the proper approach is not to adjust the tax rate applicable to the earnings stream but rather to adjust the rate of return expected by the investor.

Goodwill

In the sale of a closely held business, a valuation issue that arises is whether the owner's goodwill belongs to the corporation and should be included in the value of the closely held business, or does the owner's personal asset separate from the value of the business.

Goodwill is defined as, "[T]he ability to earn a rate of return in excess of a normal rate of return on the net assets of a business, after reasonable compensation to operating personnel." [fn 12]

[fn 12] Pratt with Niculita *Valuing a Business*, 5th edition.

Goodwill is also included in the definition of *intangible assets* in the International Glossary of Business Valuation Terms:

> Non-physical assets (such as franchises, trademarks, copyrights, goodwill, equities, mineral rights, securities, and contracts, as distinguished from physical assets) that grant rights, privileges, and have economic benefits to the owner.
>
> A secondary issue related to this is whether a covenant not to compete has a separate value or is part of the overall corporate goodwill. [fn 13]

A valuation analyst valuing a business or business interest should approach these issues as a question of fact. Arriving at an estimate of value in each case should be determined based on all relevant facts and circumstances.

Proper valuation in an estate and gift tax context is not the only issue facing a valuation analyst and his or her client (taxpayer). There are also possible income tax consequences to consider. If the business was sold, then the character of the income (capital gain versus ordinary income to the seller) must be considered, as well as whether the buyer can claim an amortization deduction when part of the stock purchase price is allocated to a covenant not to compete.

In the *Larry E. Howard* case, the court decided that capital gains treatment occurs when the buyer purchases the goodwill directly from the shareholder. However, if the goodwill belongs to the corporation, then monies paid to the shareholder could be considered a constructive distribution. In this case, the transaction would be treated as a sale by the corporation and a distribution to the shareholder. [fn 14]

In the *Estate of Adell* case, [fn 15] the Tax Court ruled that (absent a covenant not to compete or other agreement), if the key employee quit, the company could not exclusively use the customer relationships that the employee cultivated. As a result, the goodwill was an asset of the employee and not of the company. In addition, due to the employee's personal goodwill, the court agreed with an economic charge high enough to compensate the employee for the value of the customer relationships he developed. This charge resulted in reducing the value of the subject company even farther.

The issue of personal goodwill was first addressed in Revenue Ruling 57-480, 1957-2 CB 47 and clarified by Revenue Ruling 60-301, 1960-2. The IRS concluded that personal goodwill did not attach to the corporation where the business is dependent solely upon the professional skill or other personal characteristics of the owner. In contrast, the IRS went on to say that goodwill was transferable where the success is not dependent solely upon the personal characteristics of the owner even though such sale does not involve a valid assignment of the exclusive use of the firm name.

[fn 13] Covenants not to compete are contracts that, in general, prevent an individual from competing with a business for a specified period of time within a designated geographic area.

[fn 14] *Larry E. Howard v United States of America,* CA9 108 AFTR2d.

[fn 15] *Estate of Adell v. Commissioner,* T.C. memo. 2014-155 (August 4, 2014)

Thus, transferable corporate goodwill exists only when the business is not dependent on the professional skill or other personal characteristics of the owner. Corporate goodwill is the value that stays with the business exclusive of personal goodwill.

These rulings were superseded by Revenue Ruling 64-235 1964-2 CB 18, and the position of the IRS Commissioner which, in part, stated the following:

> The extent to which the consideration received upon the sale of a professional practice is attributable to goodwill will be determined on the basis of the facts involved in the particular case and not by whether the business is, or is not, dependent solely upon the professional skill or other personal characteristics of the owner.

What can be taken from this is that the IRS does not want to be held to a strict interpretation; instead, each case should be reviewed on its particular facts and circumstances.

A few examples of issues requiring careful consideration before making any judgment about whether goodwill is of a personal or corporate nature might include the following:

- Does the company have a strong reputation and brand name?
- Is an infrastructure in place to support services and maintain or increase market share?
- Does the company have a specialty or niche service, or does it simply employ one individual who is a specialist?
- Can business attributes be differentiated between the company and the specialist?
- Can value be created from firm attributes that are transferable to buyers exclusive of any specialist employed?

Some factors that can help distinguish between personal and corporate goodwill include the following characteristics.

Personal Goodwill Characteristics	**Corporate Goodwill Characteristics**
• Small, entrepreneurial business highly dependent on shareholder's personal skills and relationships. • No pre-existing non-compete agreement between the corporation and shareholder. • Personal services provided by the shareholder that are essential to the fulfillment	• Large business which has formalized organizational structure, systems, and controls in place. • Employees have pre-existing agreements with selling company (such as covenant not to compete, employment contracts, confidentiality agreements, and so on) that are owned by the company (assets of the

Personal Goodwill Characteristics	Corporate Goodwill Characteristics
of a product or service. • Sales largely depend on the shareholder's personal relationship with customers. • Product or services know-how (or both), supplier relationships, and client relationships that rest primarily with the shareholder. • Shareholder is favorably recognized within the industry.	company). • The business is not heavily reliant on the performance of personal services by the shareholder. • Company sales result from branding or name recognition (or both), sales force, and sales contracts. • Company owns contracts with customers. • The company's name does not include the shareholder's name. • The company intends to create value by making efforts to transfer knowledge, resources, information, and so on, to the company.

Appendix A

Resources and Reference List

This practice aid is intended to provide a framework for issues associated with valuations performed for purposes of estate administration and gift tax planning. CPAs seeking additional resources may investigate the following publications and websites. This list is not intended to be all inclusive.

Books and Chapters, Articles, Pronouncements, Guidelines, and Other References

1. Statement on Standards for Valuation Services No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (AICPA, *Professional Standards*, VS sec. 100).

2. *IRS Discount for Lack of Marketability Job Aid for IRS Valuation Professionals*, September 25, 2009.

3. Laro, David and Pratt, Shannon P. *Business Valuation and Federal Taxes, Procedure, Law and Perspective*, 2nd ed. (John Wiley & Sons, 2011).

4. Business Valuation Resources (BVR) *Guide to Business Valuation Issues in Estate and Gift Tax,* edited by Linda Trugman.

5. Practitioners Publishing Company (PPC)—A Thomson Business—Guide to Business Valuations—Chapter 10 Estate and Gift Tax Valuations.

6. Johnson, Bruce A., Jefferies, Spencer J., Park James R. *Comprehensive Guide to the Valuation of Family Limited Partnerships,* Partnership Profiles, Inc.

7. 20xx Executive Summary Report on Partnership Re-Sale Discounts. For each of the past 20 years, Partnership Profiles, Inc. (PPI) has published annual surveys that report the level of discounts from net asset value at which minority, non-controlling interests in non-publicly-traded real estate limited partnerships and real estate investment trusts are being purchased in the secondary market where these otherwise illiquid investments are bought and sold.

8. Hitchner, James R., *Financial Valuation: Applications and Models,* 3rd ed. (Hoboken, NJ: John Wiley & Sons, 2011).

9. Pratt, Shannon P. and Alina V. Niculita, *Valuing a Business, The Analysis and Appraisal of Closely Held Companies,* 5th ed. (New York, NY: McGraw-Hill, Inc., 2008).

10. Trugman, Gary R., *Understanding Business Valuation, A Practical Guide to Valuing Small to Medium Sized Businesses,* 4th ed. (New York, NY: AICPA, 2012).

11. Mergerstat Review 2012 (Newark, NJ, FactSet Mergerstat, LLC, 20xx).

12. Schweihs, Robert P, "Levels of Control," *Insights,* Autumn 2011, Willamette Management Associates.

13. Hood, Jr., L. Paul and Timothy R, Lee, *A Reviewer's Handbook to Business Valuation: Practical Guidance to the Use and Abuse of a Business Appraisal* (Hoboken, NJ: John Wiley & Sons, 2011).

14. Pack, J.D., Steven M., *Family Limited Partnerships: Practical Strategies and Solutions* (Self-Published, 2002).

15. Robert F. Reilly, CPA and Robert P. Schweihs, ASA, *Guide to Intangible Asset Valuation* (New York, NY: AICPA, 2013).

Appendix B

Common Acronyms Used in This Practice Aid

The following includes a list of the more commonly used acronyms in this practice aid:

- **AICPA—**American Institute of Certified Public Accountants
- **DLOC—**Discount for Lack of Control
- **DLOM—**Discount for Lack of Marketability
- **FLP—**Family Limited Partnership
- **FMV—**Fair Market Value
- **FVS—**AICPA's Forensic and Valuation Services
- **IRC—**Internal Revenue Code
- **PLR—**Private Letter Ruling
- **SSVS No. 1—**Statement on Standards for Valuation Services No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset*
- **TAM—**Tax Advice Memorandum
- **USC—**United States Code
- **VS section 100—**New codification of SSVS No. 1 in *Professional Standards*

Appendix C

Case Law

The purpose of this index is to provide a summary of cases that address, at least in part, specific subject matter topics related to estate and gift tax and valuation issues. This appendix does not establish a comprehensive list of cases, nor is it designed to assess the relevance of a case to the facts and circumstances of any case that may address similar facts and circumstances.

It is important for practitioners to note that the status of a case can change whenever a subsequent case or judicial ruling is issued (for example, change from case law with no negative appellate history to a case that gets overruled by an appellate court). Therefore, practitioners (with assistance from legal counsel) should perform their own due diligence on the status of any cases that follow to determine if the case has been overruled or if relevant negative treatment exists.

Definition of FMV

- Estate of Bright v. United States, 658 F.2d 999 (5th Circuit, 1981).

Subsequent Events

- Ithaca Trust Co. v. United States, 279 U.S. 151 (1929).
- Campbell v. United States, 661 F. 2d 209 (Circuit Court of Claims, 1981).
- Estate of Gallo v. Commissioner, T.C. Memo 1985-363.
- Estate of Jung v. Commissioner, 101 T.C. 412 (1993).
- Scanlan v. Commissioner,116 F.3d 1476 (5th Circuit, 1997).
- Saltzman v. Commissioner, 131 F.3d 87 (2nd Circuit, 1997).
- Estate of Noble v. Commissioner, T.C. Memo 2005-2.
- The Ringgold Telephone Company v. Commissioner, T.C. Memo 2010-103.

Approaches to Value

- Estate of Hall v. Commissioner, 92 T.C. 312 (1989).
- Furman v. Commissioner, T.C. Memo 1998-157.
- Estate of Hendrickson v. Commissioner, T.C. Memo 1999-278.
- Estate of Dunn v. Commissioner, 301 F.3d 339 (5th Circuit 2002).
- Estate of Weinberg v. Commissioner, T.C. Memo 2000-51.

- Estate of Klauss v. Commissioner, T.C. Memo 2000-191.
- Estate of Renier v. Commissioner, T.C. Memo 2000-298.
- Polack v. Commissioner, T.C. Memo 2002-145.
- Brewer Quality Homes, Inc. v. Commissioner, T.C. Memo 2003-200.
- Estate of Gallagher v. Commissioner, T.C. Memo 2011-148.
- Estate of Richmond v. Commissioner, T.C. Memo 2014-26.

Built-in Gains Tax

- Estate of Davis v. Commissioner, 110 T.C. 530 (1998).
- Eisenberg v. Commissioner, 155 F. 3d 50 (2nd Circuit, 1998).
- Estate of Simplot v. Commissioner, 249 F.3d 1191 (9th Circuit, 2001).
- Estate of Borgatello, T.C. Memo 2000-264.
- Estate of Dunn v. Commissioner, 301 F.3d 339 (5th Circuit, 2002).
- Estate of Jones v. Commissioner, 116 T.C. 121 (2001).
- Temple v. U.S., 423 F. Supp. 2d 605 (Eastern District, TX, 2006).
- Estate of Jelke v. Commissioner, 507 F.3d 1317 (11th Circuit, 2007).
- Estate of Litchfield, T.C. Memo 2009-21.
- Estate of Jensen v. Commissioner, T.C. Memo. 2010-182.
- Estate of Richmond v. Commissioner, T.C. Memo 2014-26.

Discounts and Premiums

- Ruston v. Commissioner, 60 T.C. 272 (1973), affirmed 498 F.2d 88 (5th Circuit, 1974).
- Estate of Gallo v. Commissioner, T.C. Memo 1985-363.
- Estate of Dougherty v. Commissioner, T.C. Memo 1990-274.
- Mandelbaum v. Commissioner, T.C. Memo 1995-255.
- Estate of Cloutier v. Commissioner, T.C. Memo 1996-49.
- Estate of Wright v. Commissioner, T.C. Memo 1997-53.
- Masonry v. Commissioner, T.C. Memo 1997-251.

- Estate of Davis v. Commissioner, 110 T.C. 530 (1998).
- Furman v. Commissioner, T.C. Memo 1998-157.
- Estate of Desmond v. Commissioner, T.C. Memo 1999-76.
- Estate of Hendrickson v. Commissioner, T.C. Memo 1999-278.
- Estate of Barnes v. Commissioner, T.C. Memo 1998-413.
- Estate of Dunn v. Commissioner, 301 F.3d 339 (5th Circuit 2002).
- Estate of Gow v. Commissioner, 19 Fed Appx 90 (4th Circuit, 2001).
- Estate of Maggos v. Commissioner, T.C. Memo 2000-129.
- Estate of Godley v. Commissioner, 286 F.3d.210 (4th Circuit, 2002).
- Estate of Borgatello, T.C. Memo 2000-264.
- Estate of Jones v. Commissioner, 116 T.C. 121 (2001).
- Estate of Janda v. Commissioner, T.C. Memo 2001-24.
- Estate of True v. Commissioner, 390 F. 3d 1210 (10th Circuit, 2004).
- Estate of Adams v. Commissioner, T.C. Memo 2002-80.
- Okerlund v. U.S., 365 F.3d 1044 (Fed. Cir. 2004).
- Estate of Deputy v. Commissioner, T.C. Memo 2003-176.
- Lappo v. Commissioner, T.C. Memo 2003-258.
- Peracchio v. Commissioner, TC Memo 2003-280.
- Estate of Jelke v. Commissioner, 507 F.3d 1317 (11th Circuit, 2007).
- Temple v. U.S., 423 F. Supp. 2d 605 (Eastern District, TX, 2006).
- Robertson v. U.S., 2006 U.S. Dist. LEXIS 1167 (Northern District, TX, 2006).
- Huber v. Commissioner, T.C. Memo 2006-96.
- Estate of Litchfield, T.C. Memo 2009-21.
- Keller v. United States, 697 F.3d 238 (5th Circuit, 2012).
- Estate of Koons v. Commissioner, T.C. Memo 2013-94.
- Estate of Richmond v. Commissioner, T.C. Memo 2014-26.

Multi-Level (Tiered) Discounts

- Whittemore v. Fitzpatrick, 127 F.Supp. 710 (D. Conn., 1954).
- Estate of Dean v. Commissioner, T.C. Memo 1960-54.
- Estate of O’Connell v. Commissioner, 640 F.2d 249 (9th circuit, 2001).
- Martin v. Commissioner, T.C. Memo 1985-424.
- Kosman v. Commissioner, T.C. Memo 1996-112.
- Estate of Gow v. Commissioner, 19 Fed Appx 90 (4th Circuit, 2001).
- Estate of Janda v. Commissioner, T.C. Memo 2001-24.
- Estate of Hjersted, 175 P.3d 810 (Kansas, 2008).
- Estate of Astleford v. Commissioner, T.C. Memo 2008-128.

Discounts for Fractional Interests

- Estate of Fawcett v. Commissioner, 64 T.C. 889 (1975).
- Estate of Sels v. Commissioner, T.C. Memo 1986-501.
- Mooneyham v. Commissioner, T.C. Memo 1991-178.
- LeFrak v. Commissioner, T.C. Memo 1993-526.
- Estate of Barge v. Commissioner, T.C. Memo 1997-188.
- Estate of Williams v. Commissioner, T.C. Memo 1998-59.
- Estate of Youle v. Commissioner, T.C. Memo 1989-138.
- Estate of Wildman v. Commissioner, T.C. Memo 1989-667.
- Estate of Brocato v. Commissioner, T.C. Memo 1999-424.
- Shepard v. Commissioner, 115 T.C. 376 (2000).
- Estate of Busch v. Commissioner, T.C. Memo 2000-3.
- Estate of Stevens v. Commissioner, T.C. Memo 2000-53.
- Estate of Forbes v. Commissioner, T.C. Memo 2001-72.
- Ludwick v. Commissioner, T.C. Memo 2010-104.
- Estate of Adler v. Commissioner, T.C. Memo 2011-28.

- Estate of Elkins v. Commissioner, 140 T.C. No. 5 (2013).

Annual Gift Tax Exclusion

- Hackl v. Commissioner, 335 F.3d 664 (7th Circuit, 2003).
- Price v. Commissioner, T.C. Memo 2010-2.
- Fisher v. U.S., 107 A.F.T.R. 2d 1893.
- Estate of Wimmer v. Commissioner, T.C. Memo 2012-157.

Qualified Appraiser/Daubert

- The Ringgold Telephone Company v. Commissioner, T.C. Memo 2010-103.
- Friedberg v. Commissioner, T.C. Memo 2011-238.
- Boltar, L.L.C. v. Commissioner, 136 T.C. No. 14 (2011).
- Estate of Richmond v. Commissioner, T.C. Memo 2014-26.

Tax-Affecting (Pass-through Entities)

- Gross v. Commissioner, 272 F.3d 333 (6th Circuit, 2001).
- Wall v. Commissioner, T.C. Memo 2001-75.
- Estate of Heck v. Commissioner, T.C. Memo 2002-34.
- Adams v Commissioner, T.C. Memo 2002-80.
- Dallas v. Commissioner, T.C. Memo 2006-212.
- Estate of Gallagher v. Commissioner, T.C. Memo 2011-148.

Key Person Discount

- Estate of Huntsman v. Commissioner, 66 T.C. 861 (1976).
- Estate of Feldmar v. Commissioner, T.C. Memo 1988-429.
- Estate of Rodriguez v. Commissioner, T.C. Memo 1989-13.
- Furman v. Commissioner, T.C. Memo 1998-157.
- Estate of Renier v. Commissioner, T.C. Memo 2000-298.
- Estate of Leichter v. Commissioner, T.C. Memo 2003-66.

Defined Value and Formula Clauses

- Hendrix v. Commissioner, T.C. Memo 2011-133.
- Estate of Petter v. Commissioner, 653 F.3d 1012 (9th Circuit, 2011).
- Wandry v. Commissioner, T.C. Memo 2012-88.

FLP-Estate Tax (Miscellaneous Issues)

- Estate of Lockett v. Commissioner, T.C. Memo 2012-123.
- Keller v. United States, 697 F.3d 238 (5th Circuit, 2012).
- Estate Koons v. Commissioner, T.C. Memo 2013-94.
- Estate of Tanenblatt. Commissioner, T.C. Memo 2013-263.

Indirect Gifts and Step Transactions

- Senda v. Commissioner, 433 F.3d 1044 (8th Circuit, 2006).
- Holman v. Commissioner, 2010 US APP. Lexis 27469 (8th Circuit, June 2010).
- Gross v. Commissioner, T.C. Memo 2008-221.
- Linton v. U.S., Cause No. C08-227Z, 630 F.3d 1211 (9th Circuit, 2011).
- Pierre v. Commissioner, T.C. Memo 2010-106.

Chapter 14 Issues

- Kerr v. Commissioner, 292 F. 3d 490 (5th Circuit, 2002).
- Church v. United States, 268 F.3d 1063 (5th Circuit, 2001).
- Estate of Dailey v. Commissioner, T.C. Memo 2001-263.
- Lappo v. Commissioner, T.C. Memo 2003-258.
- Holman v. Commissioner, 2010 US APP. Lexis 27469 (8th Circuit, June 2010).

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- Estate of Reichardt v. Commission, 114 T.C. 144 (2000).
- Estate of Harper v. Commissioner, T.C. Memo 2002-121.
- Kimbell v. U.S., 371 F. 3d 257 (5th Circuit, 2004).
- Estate of Stone v. Commission, T.C. Memo 2003-309.
- Estate Black v. Commissioner, 133 T.C. No. 15 (2009).

- Estate of Shurtz v. Commissioner, T.C. Memo 2010-21.
- Estate of Adler v. Commissioner, T.C. Memo 2011-28.
- Estate of Sylvia Riese v. Commissioner, T.C. Memo 2011-60.
- Estate of Turner v. Commissioner, 138 T.C. No. 14 (2012).
- Estate of Liljestrand v. Commissioner, T.C. Memo 2011-259.
- Estate of Stone v. Commissioner, T.C. Memo 2012-48.
- Estate of Kelly v. Commissioner, T.C. Memo 2012-73.
- Estate of Sommers v. Commissioner, T.C. Memo 2013-8.
- Estate of Trombetta v. Commissioner, T.C. Memo 2013-234.