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Gain from the Value of a Good Valuation

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Estate, gift, and generation-skipping transfer (GST) taxes all target and tax the transfer of property from a donor to a donee. Obtaining a value of the property when computing the potential tax liability and structuring transfers is essential to tax-efficient planning and proper tax reporting. With easy-to-value assets, such as cash or marketable securities, valuations are straightforward. For other assets such as closely held business interests or art, determining the correct value is a task easier said than done. If hard-to-value assets are overvalued, the taxpayer will overpay on taxes (or unnecessarily use a portion of the taxpayer's lifetime exemption). If the assets are determined to be undervalued by the IRS on audit, in addition to the time and expense of the audit and additional tax or use of credits, the taxpayer will have to pay interest on the underpayment of tax and may be subject to penalties.

As the IRS has noted, valuations are "not an exact science." Rev. Rul. 59-60, 1959-1 C.B. 237. The taxpayer, the taxpayer's estate planner, the IRS, and the courts suffer from the uncertainty associated with hard-to-value assets. The growing acceptance of formula clauses in estate planning, as in cases such as *Wandryv. Commissioner,* have provided some options to avoid the uncertainty associated with hard-to-value assets. See *Wandry v. Commissioner*, 103 T.C.M. (CCH) 1472 (2012). See also Todd Angkatavanich, Liam Crane & Stephen Putnoki-Higgins, *Gift Planning with Formula Clauses: From* Proctor*'s Progeny to* Wandry*'s World (Part 2)*, Prob. & Prop. Mar./Apr. 2014, at 37. Getting a professional appraisal of the property, however, remains the cornerstone of planning with hard-to-value assets.

In trying to make valuations have more of the certainty of science, all parties involved look to the guidance of the courts to scrutinize valuation techniques applied by the appraisers who are retained by taxpayers and the IRS. By examining these cases, planners can piece together bright line rules or preferences set forth by the courts to determine what approaches are acceptable, what qualifications an appraiser should have, and to gauge the risk when taking certain positions. The recent memorandum decision of the Tax Court in *Estate of Richmond v. Commissioner*, T.C. Memo 2014-26, provides useful guidance for planners regarding acceptable methods of valuing closely held business interests, applying a discount for the tax liability associated with the built-in capital gain

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of a corporation, and the importance of the quality of the appraisal and appraiser to avoid accuracy-related penalties.

The Asset

The taxpayer in *Estate of Richmond*, Helen P. Richmond (the "Decedent"), died a resident of Pennsylvania in 2005. At the time of her death, the Decedent owned 23.44% of the stock in Pearson Holding Company (PHC). PHC was a Subchapter C corporation formed in Delaware in 1928 by an ancestor of the Decedent, Frederick Pearson. Over the course of its existence, PHC operated as an investment holding company that held bonds and securities with the goal of maximizing income for its shareholders. PHC achieved this goal by growing capital in concentrated positions of dividend-paying stocks while minimizing capital gains taxes by having low turnover of its holdings. Approximately 87.5% of its portfolio consisted of unrealized appreciation with shares in four blue-chip stocks (Exxon, Merck, GE, and Pfizer) constituting 42.8% of the total value of the portfolio. *Estate of Richmond*, T.C. Memo 2014-26, at n.1.

For over seven decades PHC paid fairly consistent dividends each year and averaged only a 1.4% annual turnover of its securities in the decade preceding the Decedent's death. Based on the low turnover rate, it would take 70 years for the portfolio to completely turn over, which provided a significant deferral of the tax on the appreciation of the underlying securities. Despite the remarkable consistency of PHC's operations, over time the ownership of PHC had become less concentrated, so that, by the time of the Decedent's death, shares were held by 25 of Frederick Pearson's descendants, with the Decedent being the second largest shareholder. The parties and the Tax Court noted that the ownership was becoming more diffuse, such that it was likely that the shareholders would see PHC less as a family business and more like any other investment. It was agreed that this would lead the shareholders to accept financial advice to diversify the holdings, which would result in more rapid portfolio turnover.

Appropriate Valuation Approach

For estate tax and gift tax purposes, the property transferred is valued at "[t]he fair market value [which] is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell. . . ." Treas. Reg. §§ 20.2031-1(b), 25.2512-1. The fair market value of closely held business interests is commonly challenged in audits because of the difficult nature of valuing the interests. Unlike publicly traded companies in which shares are regularly traded and their fair market value is easily ascertainable by reference to an actual market, closely held business interests rarely change hands in arm's-length transactions, so the value of an interest is not easily determined. An appraisal is often necessary to establish the value for transfer tax purposes. While audits and cases often focus on the appropriateness of the discounts taken by the taxpayer, the valuation method selected by the appraiser and a potential IRS auditor sets the groundwork for the valuation of a closely held company and, as such, its importance cannot be understated.

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Although the Treasury Regulations set forth some guidance on valuing closely held businesses, the factors set forth in Rev. Rul. 59-60 and its progeny serve as the starting point generally followed by courts and appraisers. See Rev. Rul. 65-193, 1965-2 C.B. 370; Rev. Rul. 77-287, 1977-2 C.B. 319; Rev. Rul. 80-213, 1980-2 C.B. 101; Rev. Rul. 83-120, 1983-2 C.B. 170. In Rev. Rul. 59-60, the IRS laid out eight factors to be considered when appraising closely held businesses. These factors are reasonable in theory, but it is difficult to apply them in practice to an entity because the factors can be weighted differently depending on the nature of the entity. As a result, "there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value." Rev. Rul. 59-60. The factors, however, have been accepted by the courts and have been applied to mean that in each case of valuing a closely held company, all relevant facts and circumstances should be considered in determining the exact method of valuation. See, e.g., *Estate ofDavis v. Commissioner*, 110 T.C. 530, at 536–37 (1998). Without a formula to value interests in closely held companies, appraisers have developed various approaches to valuing the interests. Given the variability of the valuation factors, appraisals have evolved to be as much an art as a science.

In *Estate of Richmond*, one of the questions the court had to address was which method was appropriate for valuing PHC. The valuation report that was the basis for the value reported on the estate tax return (FMV $3,149,767) and the report prepared by the estate's expert at trial (FMV $5,046,500) used an income approach, the capitalization-of-dividends method, to value the Decedent's interest. This method determines the fair market value of an asset by estimating the income stream the company is expected to produce in the future and assigns it a present value. Discounts, such as lack of marketability or lack of control, are generally not applied when this method is used because the hypothetical willing buyer is essentially purchasing a share of the company's income stream. The application of this approach in *Estate of Richmond* appears reasonable on its face. The stated goal and the long history of PHC demonstrate that the company consistently provided an income stream to its shareholders. Given this history, a willing buyer of shares in PHC would likely expect the company to continue the same investment philosophy and dividend payments and therefore may base the purchase price on the expected income stream.

Providing additional credibility for the application of the capitalization-of-dividends method is the fact it had been used previously for valuing PHC. The court noted that between 1971 and 1993 there were nine redemptions or sales of stock in PHC. In each instance, the capitalization-of-dividends method was used. Though this was a family-owned entity, each relevant party had its own respective economic interest in ensuring that the fair market value was properly determined, and the valuation method they used provides some indication of the method a willing buyer and willing seller would use to value the interest. The capitalization-of-dividends method was also used when a shareholder died in 1999, and, assuming an estate tax return was filed, the claimed value and methodology were not challenged by the IRS.

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Despite the use of this valuation method by PHC and its shareholders, the IRS and ultimately the Tax Court rejected the use of this approach and instead found that the net asset valuation (NAV) method was appropriate for a holding company such as PHC. The estate defended its use of the income capitalization approach by citing prior cases that applied it when valuing holding companies. See, e.g., *Kohler v. Commissioner*, 92 T.C.M. (CCH) 48 (2006). The Tax Court, however, found that those cases that used the income capitalization approach were for holding companies that owned closely held operating companies or were closely held operating companies themselves.

The Tax Court determined that in the case of a holding company that held easy-to-value assets—as did PHC, which held only publicly traded bonds and marketable securities—the NAV method was more appropriate and favored by the courts. See, e.g., *Estate of Litchfield v. Commissioner*, 97 T.C.M. (CCH) 1079 (2009). In reaching this finding, the Tax Court's overriding reason can be summed up in one word—certainty. In finding that the NAV method provided greater certainty, it criticized the estate's valuation method, stating, "[B]y definition, the capitalization-of-dividends valuation method is based entirely on estimates about the future . . . and even small variations in those estimates can have substantial effects on the value determined." *Estate of Richmond*, T.C. Memo 2014-26, at 24. The "sensitivity" of the formula makes it "less reliable" than the asset-based NAV approach. Id. at 26.

In rejecting the capitalization-of-dividends approach, the Tax Court stated that the market values of each of the underlying publicly held securities "inherently reflect the market's judgment as to the projected income streams of each stock and therefore reflect the future income stream of PHC." Id. at 27. This view could be criticized as being too simplistic.

The court recognized that the market price of the underlying publicly traded securities is the fair market value if held outside of an entity, directly by the decedent. But in the case of a holding company, it is not the marketable securities that are transferred but the interest in the holding company, the value of which would require adjustments from the NAV to the extent necessary to reflect a shareholder's lack of control and lack of marketability. *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982). Having the interests in the entity brings its own valuation challenges and the *Estate of Richmond* decision notes the "difficulties and uncertainties" associated with the discounts that would apply to entities valued under the NAV method but finds that, despite these issues, the NAV method starts the appraisal process on "firm ground." *Estate of Richmond,* T.C. Memo 2014-26, at 24.

In terms of the valuation approach selected, the *Estate of Richmond* decision could be read as a bright-line rule by the Tax Court—holding companies that hold only marketable securities must be appraised under the NAV method. As the decision states, this is in line with the Tax Court's "consistent precedent of using net asset valuations for companies with holdings like PHC." Id. at 27. See also *Estate of Litchfield*, 97 T.C.M. at 1079. What is especially noteworthy about this case and other cases dealing with companies that have long track records like PHC is that such a bright-line rule may not match up with the overriding albeit less clear rule that is the willing seller/willing buyer standard.

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The IRS has noted that, in applying the willing buyer/willing seller test, "all relevant factors available to either buyer or seller, known to both, provide a basis on which the buyer and seller make a decision to buy or sell and come to an agreement on the price." Rev. Rul. 78-367, 1978-2 C.B. 249. In the case of PHC, it is understandable why the parties selected the capitalization-of-dividends method to value the company. A hypothetical seller would have highlighted PHC's consistent track record and bond-like return over 75 years to a potential buyer to demonstrate that PHC provides a reliable income stream. Likewise, if PHC had volatile performance or sporadic dividend payments in the past decade, the hypothetical buyer would likely purchase PHC at less than the combined net value of its assets. This is how the company had historically been valued by the parties. The point is that, while the capitalization-of-dividends appears to be a reasonable method in valuing PHC, the Tax Court appears willing to rigidly apply the NAV method to closely held investment entities holding publicly traded securities, believing that the NAV method provides more certainty.

The Built-in Capital Gain Discount

Unsurprisingly, because of the adoption of an NAV approach to valuation, *Estate of Richmond* reflects a disagreement between the estate and the IRS over the appropriate discount for lack of control and lack of marketability. As with many prior valuation cases, the Tax Court was left in the position of weighing the opinions of the experts and determining in Solomonic fashion what the correct discounts should be. What is notable in *Estate of Richmond* is a third discount—one for the tax liability on the built-in capital gains (BICG). The BICG reduces the fair market value of a corporation based on the tax liability that would be incurred on appreciated assets held in the entity if they were sold or the company was liquidated. This discount is not appropriate when applying the capitalization-of-dividends method because that approach focuses on the expected income stream. A discount for the BICG tax liability is appropriate under the NAV method because it is a liability of the entity being appraised.

The application of this discount is relatively recent. Before the 1986 revisions to the Internal Revenue Code, the potential tax liability of a corporation was too speculative to take into consideration, given the ability to avoid a corporate level tax in the event of a corporate liquidation under the *General Utilities* doctrine. See *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935). After the Tax Court's decision in *Estate of Davis* and the IRS's acquiescence to the Second Circuit's decision in *Eisenberg* recognizing that some form of discount was appropriate, it is generally accepted that the existence of BICG would have an effect on the price a willing buyer would pay for an interest in a corporation. *Estate of Davis*, 110 T.C. at 530; *Eisenberg v. Commissioner*, 155 F.3d 50 (2d Cir. 1998), acq., AOD 1999-001, 1999-4 I.R.B. 4. The courts have provided no clear guidance, however, on how the discount should be calculated. The *Estate of Richmond* decision further demonstrates the need for guidance from the U.S. Supreme Court on this issue and the theoretical inconsistency in the IRS's as well as the Tax Court's approach.

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The issue of BICG was especially important in the case of PHC given the appreciation of its holdings over the years with extremely low turnover. At the time of the Decedent's death, PHC held $52,159,430 in assets and had $45,389 in nontax liabilities. Approximately 87.5% ($45,576,677) of the assets, however, constituted unrealized appreciation. The parties agreed that PHC had a BICG liability of $18,113,083, meaning that there was an additional tax liability as of the valuation date of approximately $18.1 million.

The *Estate of Richmond* decision and previous court rulings found that the existence of BICG would reduce the fair market value of the holdings of PHC. In *Estate of Richmond*, Judge Gustafson noted that a willing buyer would not pay $52 million to acquire the $52 million worth of stock held by PHC even if it could be liquidated immediately without restrictions. Given the BICG and the tax liability associated with it, a willing buyer would be better off purchasing the exact same portfolio of publicly traded securities in the public market for $52 million rather than an interest that had the equivalent underlying value in PHC because the securities purchased directly would be full basis assets with no BICG at the time of purchase. Although the IRS did not explicitly take the BICG into account in its notice of deficiency to the estate, at trial all parties agreed that a discount to the estate's holding in PHC was appropriate. They disagreed, however, over how large the discount should be.

The estate's expert, in calculating the Decedent's interest using the NAV method as an alternative valuation method, took the position that the discount should be a dollar-for-dollar reduction for the tax liability as though the company were liquidated as of the valuation date. Under this approach, the $52 million value of PHC's marketable securities would be reduced by the $18.1 million of tax. This position treats the BICG tax liability like any other liability of the entity. Both the Fifth Circuit and Eleventh Circuit have adopted this position. *Estate of Dunn v. Commissioner*, 301 F.3d 339 (5th Cir. 2002); *Estate ofJameson v. Commissioner*, 267 F.3d 366 (5th Cir. 2001); *Estate of Jelke v. Commissioner*, 507 F.3d 1317 (11th Cir. 2007). The IRS, however, took the position that only a $7.8 million reduction in value was appropriate. The IRS's expert based its discount on allowing a dollar-for-dollar discount on the tax attributable to the appreciation of stock in PHC to the extent it exceeded 50% of the company's value. He concluded that potential buyers were indifferent to the tax liability in the closed-end funds he had studied that had unrealized appreciation accounting for up to 50% of the fund's NAV. See *Estate of Richmond,* T.C. Memo 2014-26, at 33. The IRS's expert then added this discount to the overall discount for lack of marketability.

The court rejected both approaches but accepted the IRS's $7.8 million discount under its own approach. As a preliminary matter, Judge Gustafson noted that the BICG discount is not part of the lack of marketability discount. A discount for lack of marketability is based on the fact that there is not a readily available market for closely held companies; thus the value of the entity interest is reduced. The BICG discount, however, "affects the net asset value," as it is a liability of the entity and as such reduces the value of the underlying assets of the entity. Id. at n.20.

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In determining what the discount should be, Judge Gustafson held that "we consider [the dollar-for-dollar] discount plainly wrong in a case like the present one." Id. at 30. This finding relied on prior Tax Court rulings and other circuit court decisions that highlight the current uncertainty in calculating the appropriate discount for BICG. See, e.g., *Estate of Davis*, 110 T.C. at 530. The Tax Court cited to the Second Circuit's 1998 decision in *Eisenberg* that a dollar-for-dollar discount is inappropriate, but the Second Circuit did not explain how the discount should be calculated. *Eisenberg,* 155 F.3d at 58 n.15. Judge Gufstason also relied on an unpublished Sixth Circuit decision, which similarly gave no guidance on how to calculate the appropriate discount for a BICG liability and only went so far as to state that the estate "may not be entitled to deduct the full amount of that liability, particularly in the absence of any expert testimony to support such a discount. . . ." *Estate of Welch v. Commissioner*, 208 F.3d 213 (6th Cir. 2000).

The Tax Court reached its determination of the appropriate discount by using a "present value approach" to determine the value of the BICG liability. Though PHC had a historic turnover rate that suggested it would take 70 years completely to turn over the portfolio, the parties agreed that in light of the growing number of shareholders and recent investment advice to diversify the holdings, it was more realistic that the portfolio would turn over during the course of the next 20 to 30 years. In calculating the present value over this shortened time frame, the court concluded that the present value of the BICG liability could be anywhere between $5.5 and $9.6 million. Because the IRS's $7.8 million discount fell within this range, the court accepted it as the appropriate discount. *Estate of Richmond,* T.C. Memo 2014-26, at 33.

Even though the Tax Court's rejection of a dollar-for-dollar discount for the BICG liability was not taxpayer-friendly, practitioners may look to two bright spots in this decision. The first is that Judge Gustafson gave a thoughtful and detailed explanation of why he found the dollar-for-dollar approach inappropriate, which served to highlight the logical inconsistency of the holding. The second is that this case shines a light on the need for consistency among the courts on this issue.

The Tax Court's opinion had one foot on the "firm ground" of NAV and the other on the soft ground of predictions and estimates. The court rejected the use of the dividend capitalization approach because such a valuation was "based on estimates." Instead, the court believed it appropriate to start on "firm ground" by using the market value of underlying, easy-to-value assets as of the date of death to avoid the uncertainties of estimates and projections when valuing the company.

There is a fundamental inconsistency in not allowing a dollar-for-dollar discount for the BICG as a liability of the company when applying the NAV method. On the one hand, the Tax Court used the value of PHC's marketable securities as of the date of death instead of estimating the present value of the dividend stream from the company. Further demonstrating this inconsistency, PHC had $45,389 in liabilities (excluding the BICG liability) on the valuation date that reduced the value of PHC dollar-for-dollar discount under the NAV approach. For PHC's BICG liability calculated as of the valuation date, however, the Tax Court only allowed $7.8 million of the $18.1 million tax liability (a

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difference of $10.3 million) by adjusting that liability for its present value based on assumptions and estimates of how PHC would act over the course of the next 20 to 30 years. These estimates varied by a range of $4.1 million. Valuing the BICG liability in this manner exposes the valuation to the same uncertainties of estimates and projections that the court found unacceptable with the dividend capitalization approach. Why does that same concern for certainty not exist for this particular liability? If the court was concerned with certainty, it could have been achieved with a true liquidation approach that would have necessitated a dollar-for-dollar discount because the tax would have come due immediately if the company liquidated.

The *Estate of Richmond* decision uses an example to buttress its position with a hypothetical holding company that had an $18.1 million note payable the date after the transfer. In this example, a potential buyer would expect a greater reduction in sales price than a potential purchaser of PHC who would have the tax liability potentially deferred for years. If a hypothetical willing buyer is expected to make estimates regarding when the tax liability would be incurred, wouldn't that same buyer determine the price he is willing to pay by estimating the expected performance of the company? The Tax Court in *Estate of Richmond* would say no—the hypothetical buyer only estimates when liabilities would be incurred. How would that same hypothetical buyer treat a note payable over 30 years instead of tomorrow? Under the NAV method, it would be a dollar-for-dollar discount of the face value of the note and not a present value calculation. Furthermore, for gift and estate tax purposes, notes are presumed to be valued at their face value regardless of their repayment terms. See Treas. Reg. §§ 20.2031-4, 25.2512-4. If the hypothetical buyer applying the NAV method would insist on a dollar-for-dollar discount on a debt due tomorrow or 30 years from now, why would he not insist on the same treatment for a BICG liability that could be paid over 30 years as the stocks are turned over? Or, alternatively, if the willing buyer is expected to retain the property over 30 years as the gains gradually are realized, then why is it inappropriate for him to value the interest based on a capitalization-of-dividends approach?

Is the dollar-for-dollar discount perfect? Of course not. It applies a bright-line rule, but that is what the NAV method attempts to do across the board. The dollar-for-dollar discount is consistent by treating the assets and liabilities the same across the board. It is more consistent than the Tax Court's approach of simply doing a present value adjustment for the anticipated realization as of the valuation date. This is especially true in the case of PHC, in which the anticipated realization of the entire BICG liability had been reduced from a historic 70 years to a projected 20 to 30 years as of the valuation date. We are all aware of the typical SEC-required legends on investment materials warning that past performance is no indicator of future performance. This highly concentrated, highly appreciated portfolio could be sold tomorrow. Even if one is willing to delve into estimates, there is a more artful and potentially accurate way of making such estimates than the IRS and Tax Court have sought to apply in this case. See Scott Andrew Bowman, *Built-in Gain Discounts for Transfer Tax Valuation: A Resolution for the Big Debate*, 24 Akron Tax. J. 117 (2009).

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This raises the second point in which practitioners may be able to take solace—the chance of getting a final resolution of this issue. The Fifth Circuit and Eleventh Circuit have found that the dollar-for-dollar discount for the BICG is appropriate. The Tax Court, Second Circuit, and arguably the Sixth Circuit have found that less of a discount is appropriate, though these circuit courts have not given clear guidance on how to determine the correct discount. If the *Estate of Richmond* decision is appealed and the Third Circuit issues an opinion on the issue, the circuit split will increase from 2-2 to 3-2 (one way or the other). At this point, the spectrum of opinions and arguments has been given, and, with a clear divergence in the circuits, a resolution is needed. The U.S. Supreme Court turned down the opportunity to resolve this issue in 2008 when it denied the appeal of the Eleventh Circuit's ruling in *Estate of Jelke*. *Estate of Jelke v. Commissioner*, 507 F.3d 1317 (11th Cir. 2007), rev'g, 89 T.C.M. (CCH) 1397 (2005), cert. denied, 555 U.S. 826 (2008). Hopefully, *Estate of Richmond* will provide an opportunity to resolve the appropriate discount for BICGs to give certainty on an issue that is common in valuations of Subchapter C corporations that hold appreciated assets.

Getting a Good Valuation

Of more concern for most planners about *Estate of Richmond* is the Tax Court's imposition of a 20% accuracy-related penalty on the estate for a substantial estate tax valuation understatement under IRC § 6662. The risk of accuracy-related penalties is a driving motivator for planners to recommend, and taxpayers to obtain, a professional valuation of property passing by gift or on death. The Tax Court's decision in *Estate of Richmond* drives home the value of a good appraisal.

An understatement of an estate tax valuation is substantial if the value of any property claimed on the estate tax return is 65% or less than the value as finally determined. IRC § 6662(g)(1). The penalty is increased to 40% for a gross valuation misstatement, which applies if the value of the property claimed on the tax return is 40% or less than the value as finally determined. IRC § 6662(h)(2)(C). In both cases, the penalty is not imposed if it is shown that there was reasonable cause for the understatement and the taxpayer acted in good faith. IRC § 6664(c)(1).

What constitutes reasonable cause and good faith depends on the facts and circumstances. Treas. Reg. § 1.6664-4(b)(1). In *Estate of Richmond*, the taxpayers valued the stock on the estate tax return using the value from a draft valuation report prepared by an experienced certified public accountant (CPA) using a valuation method that had historically been used by shareholders of PHC. Nonetheless, based on a review of the facts the court did not find that the estate acted with reasonable cause and in good faith.

To find reasonable cause and good faith, the Regulations state that "generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability." Treas. Reg. § 1.6664-4(b)(1). The Regulations go on to state that "reasonable cause and good faith ordinarily is not indicated by the mere fact that there is an appraisal of the value of property." Id. Factors to consider include (1) the methodology and assumptions underlying the appraisal, (2) the appraised value, (3) the relationship

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between appraised value and purchase price, (4) the circumstances under which the appraisal was obtained, and (5) the appraiser's relationship to the taxpayer or to the activity in which the property is used. Id. In addition, the taxpayer's particular experience, knowledge, and education are considered. Id.

Estate of Richmond

The executors in *Estate of Richmond* engaged a CPA, Peter Winnington, to value the Decedent's stock. The executor primarily responsible for obtaining the valuation was himself a CPA and had previously worked as an accountant for PHC. The second executor had some business background, having attended business school and having some experience with financial matters.

To complete the valuation, Winnington was given information about PHC's history, audit reports, corporate tax returns, investment reports, information on stock transactions that occurred in the 1990s, and valuations prepared for prior estates that included the stock. Winnington was not a certified appraiser, as the court pointed out, but he had a bachelor of science degree in accounting and a master of science in taxation, had been employed as a CPA for nearly 20 years, and was chair of the firm's corporate service department and a member of the firm's executive committee. In addition, he had some valuation experience, having prepared 10 to 20 valuation reports and testified in court before the Richmond valuation.

Based on the information provided and using a capitalization-of-dividends approach to value the stock, Winnington prepared a draft report showing a value of $3,149,767. As discussed in detail above, this approach was the same used in the prior valuations for shareholders and was supported by PHC's steady history of dividend payments to its shareholders. Winnington was never asked to finalize the report, but the value from the unsigned draft report was the basis for the value reported on the estate tax return.

During the audit, the estate engaged Robert Scheihs to prepare a second appraisal. Also using a capitalization-of-dividends approach to value the stock, Scheihs's report determined the Decedent's interest in PHC to be worth $5,046,500. Scheihs was offered and accepted as an expert in business valuation at trial. *Estate of Richmond*, T.C. Memo 2014-26, at 16. Winnington was called to testify as a fact witness but he was not offered as a valuation expert and the draft report he prepared was not discussed at trial other than to say that it used the capitalization-of-dividends approach. Id. at 49.

In considering the estate's reasonable cause argument, the Tax Court noted the following facts: Winnington had limited appraisal experience and lacked appraiser certifications, he was not proffered as an expert in valuation at trial, his report was never finalized or signed, and the determination of value in the draft report was not explained at trial. Id. at 49–50. The fact that the executor coordinating with Winnington was also an experienced accountant who was very familiar with PHC may have been an additional factor in the court's decision.

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These factors, taken as a whole, could have supported a finding that the estate did not act in good faith with reasonable cause in claiming the value from the draft report on the Decedent's estate tax return. The Tax Court, however, took the opportunity in *Estate of Richmond* to make a stronger statement. Specifically, it stated:

While we do not disagree with the estate's assertion that the decedent's interest in PHC may be difficult to value, we believe that this further supports the importance of hiring a qualified appraiser. In order to be able to invoke "reasonable cause" in a case of this difficulty and magnitude, the estate *needed to have the decedent's interest in PHC appraised by a certified appraiser.*

Id. at 50 (emphasis added).

Appraisers

The court references both a "certified appraiser" and a "qualified appraiser." A "certified appraiser" is not a defined term in the Internal Revenue Code, but it is an industry term. State laws and regulatory agencies generally have a procedure for the licensing or certification of appraisers. Certain national appraisal organizations also provide certifications. Typically, to be certified as an appraiser, an individual must have passed an exam and have a minimum number of training hours. A "qualified appraiser" is a defined term in IRC § 170 and relates to appraisals of charitable deduction property. To be a qualified appraiser, an individual needs more than a certification to meet the minimum education and experience requirements. See IRC § 170(f)(11)(E); Treas. Reg. § 1.170A-13(c); Rev. Notice 2006-96, 2006-2 C.B. 902.

The Tax Court's statement indicates that when valuing hard-to-value assets, a "qualified appraiser" is ideal but a "certified appraiser" is necessary to obtain relief from accuracy-related penalties. This statement is troubling because a certified appraiser is not required by the Code, Regulations, or prior case law. The Regulations do require that the claimed value of certain charitable deduction property be based on a "qualified appraisal" by a "qualified appraiser" and that the taxpayer must have made a good faith investigation of the value of the property to qualify for the reasonable cause exception. See Treas. Reg. § 1.6664-4(f). The absence of this requirement in the gift and estate tax context (and the absence of a lesser, certified appraiser requirement) shows that having a qualified appraiser or certified appraiser is not necessary to obtain reasonable cause relief.

In fact, taxpayers have been found to have acted with reasonable cause and in good faith in prior cases in which there was a substantial or gross valuation misstatement and the valuation had not been prepared by a certified appraiser. For example, the Eighth Circuit overturned the Tax Court's imposition of accuracy-related penalties in finding that the estate's reliance on an experienced CPA with no formal appraisal training to value stock in a closely held company was reasonable. See *Estate of Berg v. Commissioner*, 976 F.2d 1163 (8th Cir. 1992). More recently in 2010, the Second Circuit affirmed the Tax Court's decision not to impose accuracy-related penalties when the estate relied on a valuation report prepared by an attorney and accountant. See *Estate of Thompson v. Commissioner*,

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370 Fed. Appx. 141 (2d Cir. 2010). Quoting the Tax Court's decision, the Second Circuit said:

In addition to re-emphasizing the difficult nature of the asset valuation at issue, and acknowledging that the Tax Court was not "enamored with" the Estate's chosen experts, it concluded that the experts, while "'not sophisticated valuation experts," were "sufficiently credible and sufficiently qualified . . . to have their opinions considered by the Court."

See id. at 143.

A 2004 Tax Court decision provides an extreme example. There, the taxpayer had claimed a value for a 20% interest in a closely held entity of $1.75 million based on a valuation report prepared by a lawyer who occasionally performed valuations, assisted by an accountant. The correct value was determined by the court to exceed $13.5 million. The court found an accuracy-related penalty was inappropriate, noting that the "valuation . . . was particularly difficult and unique." See *Estate of Thompson v. Commissioner*, 88 T.C.M. (CCH) 48 (2004). These examples show that a certified appraiser has not been required to relieve an estate of an accuracy-related penalty, even when the valuation was considered difficult.

Using a "qualified appraiser" to prepare a "qualified appraisal," however, is seen by many as a best practice for taxpayers obtaining property valuations for gift and estate tax purposes, not only in the context of relief from accuracy-related penalties but also for purposes of adequate disclosure on a gift tax return under Treas. Reg. § 301.6501(c)-1(f), which is necessary to begin to toll the statute of limitations on the return.

Recognizing the Value of a Valuation

The value of getting a good appraiser who can produce a good appraisal of a taxpayer's hard-to-value assets cannot be overstated. Quality valuations usually more than pay for themselves by protecting against an over-valuation, which wastes estate or gift tax credits or triggers unnecessary tax, or an under-valuation, which may result in a substantial and unexpected tax bill. Submitting a quality valuation report with an estate or gift tax return also minimizes the risk of audit and protects a taxpayer from accuracy-related penalties in the event of significant valuation adjustment. Experienced appraisers will generally know the preferences of the IRS and the courts to apply bright-line rules when appropriate to further bolster the likelihood of a reasonably accurate valuation. Likewise, they should also have more of an awareness of unresolved issues such as the discount for the BICG tax liability and preferences such as applying the NAV method when valuing a holding company with marketable securities. The complex issues involved with valuations and their importance to planning further demonstrate that attorneys must be aware of these issues and advise clients to retain appraisers who will pass muster with the IRS and the courts.

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