

20 Ways to Avoid an IRS Appraisal Audit

Some of the suggestions outlined below are simple common sense, while others tackle more complicated valuation matters. Nonetheless, tax attorneys, CPAs, and financial professionals will want to review the following list of the most common tax-related appraisal errors in an effort to avoid an IRS audit:

1. Math errors. This is an obvious recommendation that bears repeating, because even a simple math error may raise a red flag to an auditor, and/or result in a significant misstatement of value.

2. Recent and relevant data. In the current economy, make sure the appraiser has used industry and market data that are not so aged as to be unreliable or irrelevant.

3. Qualified appraiser. Does the appraiser have proven expertise in the field? Make sure the appraiser has the appropriate credentials to perform a particular appraisal, and has not crossed over into practicing law by asserting legal conclusions.

4. Appropriate discounts. Make sure any discounts “fit” the facts of the case and are appropriate to the interests at issue.

5. Clarity of the conclusion. The appraiser should clearly explain what method or weights were applied and how they were reconciled to the ultimate valuation conclusion.

6. Reality check. Check the bottom-line conclusion against this question: Would a reasonable person be willing to sell/buy the company for that amount?

7. Avoid intrinsic values. Remember, tax-related appraisals must account for the hypothetical nature of fair market value.

8. Avoid appraiser bias. Business appraisers must be able to demonstrate the reasonableness, independence, and objectivity of their valuation conclusion.

9. Avoid bias in the data. Appraisers should be able to cite independent support for their selection of data; anything that skews the valuation in an obvious direction will raise a red flag.

10. Stick to the facts. An appraiser’s opinion must be supported by the specific facts and circumstances of any case.

11. Comparable companies. Any use of guideline comparable companies in a market approach to valuation should account for the specifics (cash flow, earnings, etc.) of the transaction data vis-à-vis the subject company.

12. Pay attention to the assets. Stand back from the appraisal and make sure it values the particular rights and ownership interests at issue. In an intellectual property valuation, for example, did the appraiser value a prototype, the rights associated with it, or something else?

13. Focus on the future. Instead of focusing on historic cash flows, for example, the appraisal should consider what will happen to the cash flows going forward.

14. Pay attention to capital structures. Make sure the appraisal assesses this factor in relation to the facts of the case, use of guideline companies, the subject company, etc.

15. Discount and cap rates. Consider: Is the appraiser’s growth rate appropriate for the subject company’s first two years, or for years three and four?

16. Adjust income statements. Typically, reasonable compensation for officer and directors is the most common focus of IRS inquiry, for the smaller firms. Make sure the appropriate adjustments have

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been made to determine reasonable compensation for the particular entity.

17. Watch tax-affecting. Consider the facts and circumstances of each case in terms of the appropriateness of tax affecting, and whether it matches the growth and capital requirements of the subject company.

18. Address intangibles. For valuation of intellectual property and other complex assets, you may want to consider obtaining a separate appraisal.

19. Premise of value. Make sure the premise of value—going concern versus liquidation value, for example—fits the facts of the case and the assets and enterprise at issue.

20. Document, document, document. Make sure the appraiser can fully support the assumptions in the valuation and documents the valuation of inventory, accounts receivables, etc. at fair market values.

Statutory Fair Value Versus Fair Market Value: A Brief Historical Perspective

The two most prevalent standards of value in federal and state litigation matters are fair market value (FMV), as used and defined in bankruptcy code and tax cases, and statutory fair value, most often applied in shareholder dissent and oppression cases. (Note that this discussion does not include “fair value” as defined by the Financial Accounting Standards Board in its financial reporting and accounting statements.)

In purely linguistic terms, if you remove the “market” modifier, fair value takes on the broad meaning of a “value” that is “fair.” An asset’s *fair* value could be its market value, intrinsic value, strategic or investment value; its liquidation or going concern value. As a result, the standard gives a court wide discretion in reaching an ultimate conclusion of fair value. Perhaps that explains why there is still no universal definition of fair value in the context of dissent and oppression cases.

By contrast, the definition of *fair market value* is well-established in legal, tax, and accounting settings, and is generally more limited to an asset’s exchange value in the context of a real or hypothetical sale. Interestingly, however, the definition of fair value in *Black’s Law Dictionary* says, “see *fair market value*,” and provides a bankruptcy case by way of example, in which the court uses the term *fair value*. This circular referencing has muddied the distinction between the two concepts in a broader legal context. Over the years, however, specific precedent, statutes, and commentary have helped distinguish them in more particular cases.

At the beginning of the 20th century, litigation involving business valuations began to emerge. The American Bar Association drafted its Model Business Corporation Act, which helped state legislatures to codify dissenters’ rights statutes. The 1933 Illinois Business Corporation Act became the model for shareholder oppression statutes, and in the early 1940s, California instituted the first statutory buy-out remedy in the shareholder oppression context. In 1950, the Delaware Chancery Court issued its landmark decision in *Tri-Continental Corp. v. Battye* (1950 Del. LEXIS 23), finding that fair value entitled the stockholder in a statutory dissent case “...to be paid for that which has been taken from him, viz., his proportionate interest in a going concern.”

Similarly, the definition of fair market value began to emerge during the 1920s, through various case decisions that begin to discuss the concepts of willing buyer, willing seller, lack of compulsion and full knowledge (“known or knowable”) of the relevant facts.

Businesses began to change during the latter half of the 20th century. Once their most valuable assets, “bricks and mortar” (real property and equipment) were replaced by intangibles such as patents, trademarks, trade names, and goodwill. Disputes over the disposition of intangible assets required more complex business valuations in the judicial context. At the same time, the concepts of equitable distribution in divorce matters and the codification of fair market value Treasury Regulations and IRS Rulings began to establish a body of case law that defined and refined the FMV standard of value. As of the present date, the U.S. Tax Courts continue to confront fair market value issues including shareholder-level discounts, trapped-in capital gains, and the effect of subsequent events. Family courts still struggle with the treatment of professional and practice goodwill, the application of discounts, and the effect of buy-sell agreements.

Similarly, the past 30 years have also seen significant developments in the context of shareholder disputes. As more states adopted versions of the model business corporation statute, including its buy-out provision and the prohibition against application of discounts in amended versions, the fair value remedy has become more prevalent and available to oppressed/dissenting shareholders. Previously, for example, courts were reluctant to dissolve a company unless its conduct was particularly egregious. With the institution of the statutory buy-out remedy, courts became willing to compensate minority shareholders with the fair value of their stock. Finally, the decision by the Delaware Supreme Court in *Weinberger v. UOP, Inc.*, 457 A.2d 701, 713 (1983), held that customary and current valuation techniques may be used in determining fair value in shareholder dissent cases.

Case Includes a List of Facts By Which to Assess a FLP's Non-Tax Business Purpose

***Estate of Hurford v. Comm'r*, 2008 WL 5203652 (U.S. Tax Ct.) (Dec. 11, 2008)**

***An abbreviated version of this article appeared in our 2009 Winter edition.**

"It is a truth universally acknowledged that a recently widowed woman in possession of a good fortune must be in want of an estate planner." So begins Judge Holmes' latest Tax Court opinion considering the formation and funding of family limited partnerships (FLPs). This case, however, was further complicated when the widow was stricken with cancer. "She lost her life to the cancer," the court said. "We must now decide how much of her estate will be lost to taxes."

While she was still alive, the widow's estate was worth over \$14.2 million, consisting primarily of deferred compensation in the form of phantom stock (\$5.5 million) plus real property, life insurance, and stocks and bonds. Her attorney recommended that she create three FLPs for the various assets and take a 96% limited partner (LP) in each. Her three children would hold 1% LP interests and an LLC would serve as the 1% general partner. In addition, the widow would sell her 96% interest to the children via a private annuity transaction.

Sloppy legal work. Unfortunately, the attorney was "sloppy" and "unsteady" in drafting the controlling agreements. To avoid gift taxes, he also created the children's LP interests before funding the FLPs. Last but hardly least, the attorney failed to get current, independent appraisals of the assets that funded the FLPs. Instead, he used the values listed on the husband's estate tax return, without any effort to consider changes in their values. Similarly, he failed to obtain independent appraisals of the appropriate discounts to the interests. After bragging to the children that he had obtained discounts from the IRS as high as 50%, he picked discounts ranging from 25% to 42%, with no clear basis for the percentages. His values for the private annuity transaction were similarly unsupported and his drafting accomplished the sale of Mrs. Hurford's 96% interest to only two of her three children.

After Mrs. Hurford died less than a year later, her attorney prepared her estate and gift tax returns. The returns reported that each of the children's interests in the FLPs increased from 1% to 33%, based on substantial capital contributions, while Mrs. Hurford's 96% LP interest dwindled to 0%. In addition, the attorney denied that the decedent held any partnership interests at the time of her death or made any qualified

transfers under IRC Sections 2035, 2036, 2037, or 2038. Finally, her returns reported no taxable gifts and requested a refund of over \$238,000.

The IRS assessed substantial deficiencies for both Mrs. Hurford's estate tax return (\$9.8 million) and her gift tax return (\$8.3 million), plus over \$3.5 million in combined penalties. At trial, the Tax Court's main consideration was what assets to pull back into the estate; in particular, whether Mrs. Hurford's transfers to the FLPs and the subsequent private annuity transaction were valid under Sections 2035, 2036, and 2038.

Apart from some minor concessions, the estate argued that the decedent's tax returns were correct. It acknowledged her attorney's "sloppiness," but claimed that all the transfers were bona fide sales for adequate consideration; and that the decedent had not retained any rights to the transferred property. By contrast, the IRS attacked the entire estate plan as "nothing more than a transparently thin substitute for a will." The decedent kept control over all the assets, it claimed, and the exchange of her LP interest for the private annuity was not a bona fide transaction.

The estate retained two independent appraisers to try and "clean up some of the problems" caused by the attorney. They testified that his discount percentages were within acceptable limits, and that even if his FLPs values were incorrect, the private annuity payments (\$80,000 per month) exceeded what they would have been if the attorney had valued the FLPs correctly.

The court was not persuaded, and held that both the decedent's transfer of property to the FLPs and their subsequent exchange by the private annuity arrangement with her children were void for lack of fair and adequate consideration. The private annuity, in particular, was "a sham" and a substitute testamentary device. The decedent commingled her own funds with the partnership funds until shortly before she died—and long after she supposedly traded her FLP interests for the private annuity.

Further, the attorney "conjured the partnership discounts out of the air," the court said, and "put the same lack of effort" into valuing the FLP assets and the interest sold by private annuity. He should have retained independent appraisals to determine the fair market value of the properties at the time of the transfer, "so that the value of the annuity received would be roughly equal to that of the property sold." He also disregarded partnership formalities by delaying the funding of the FLPs for several months after they were formed. The FLPs provided no legitimate, non-tax business purpose other than serving as a "holding pen" to fund the monthly annuity payments, the court said. Finally, the attorney made "egregious" errors

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on the decedent's tax returns. The amounts claimed as capital contributions appeared to be "complete fictions," according to the court; the children received their LPs interest gratis. Based on all the evidence, the court ignored the private annuity and pulled all of the FLP assets back into the decedent's estate.

A laundry list of FLP factors. In compiling these findings and reviewing prior case law, the Tax Court also culled a comprehensive list of facts by which to assess an FLP's non-tax business purpose, including whether:

1. The FLP has consistently adhered to partnership formalities.
2. The taxpayer is financially dependent on distributions from the FLP.
3. The taxpayer has commingled personal funds with partnership funds.
4. The taxpayer has delayed or failed to transfer the property to the partnership at formation.
5. The taxpayers is old or in poor health when forming the FLP.
6. The FLP functions as a business enterprise or is otherwise engage in meaningful economic activity.
7. The FLP has pooled assets in the interest of creating "true joint ownership" or starting a new enterprise.

8. The minority owners, at a minimum, have received their interests by gift or by contributing their own assets and/or services.

Considering the entities in this case, the court found that they existed only to satisfy the Hurfords' "drive for a discount." In deciding the final question— whether to apply a discount for lack of marketability and lack of control to the FLP assets in the estate—the court looked to whether the decedent and her children had an implied agreement that she would retain control over the property for her lifetime. Prior cases have found implied agreements when the decedent: 1) transferred nearly all of her assets to the FLP, but 2) her relationship to the assets remained largely the same; and 3) she continued to use FLP assets to pay personal expenses.

The attorney's plan "plunges this case right into these precedent," the court held. The FLPs were "shuttled right into the private annuity just weeks after they were created and before they were fully funded" with nearly all of the decedent's assets. Then she received these assets back in the form of private annuity payments, which she used to pay her living expenses. Accordingly, under IRC Sections 2035(a) and 2036(a)(1), the court disallowed any discounts for the FLPs.

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