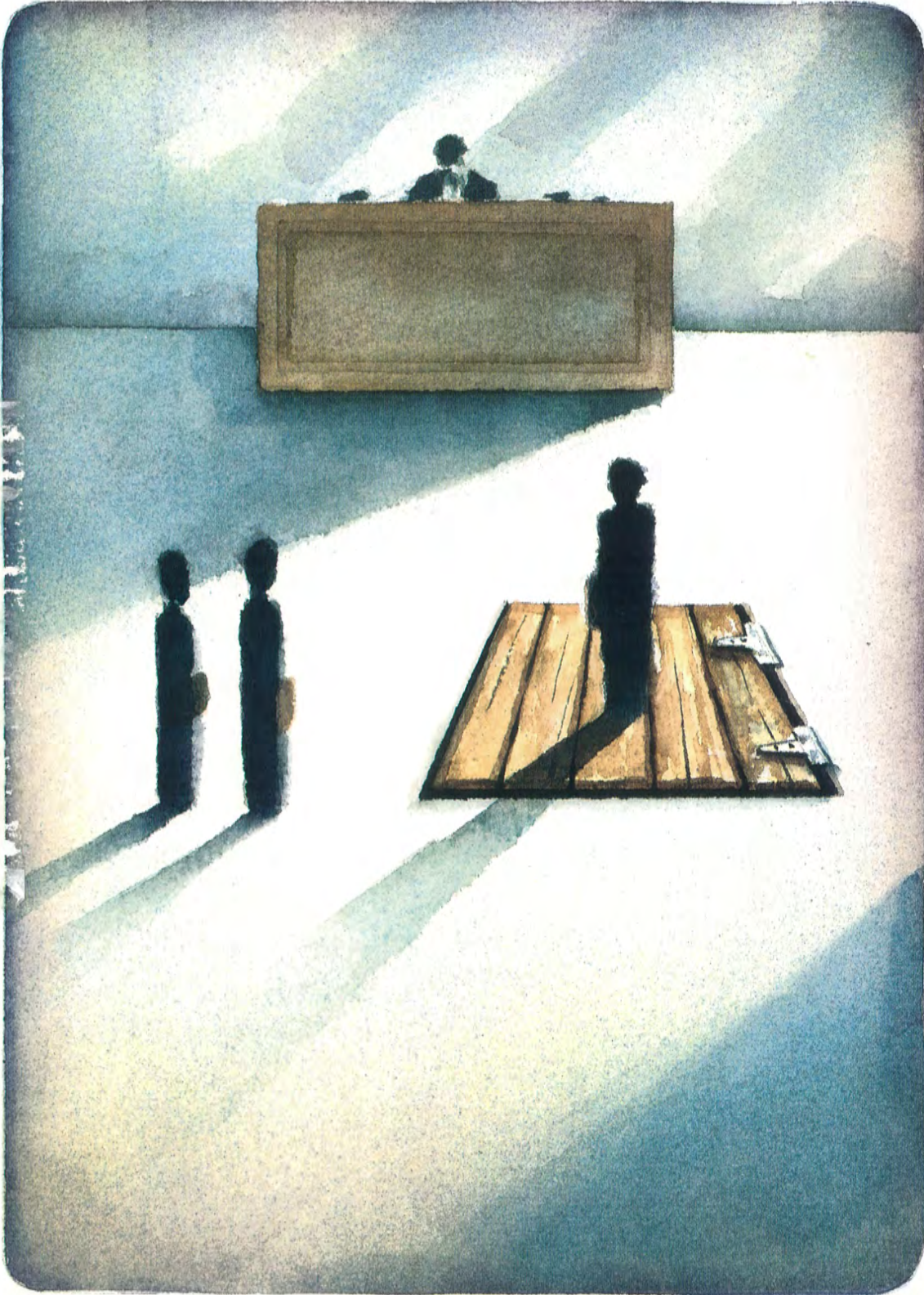


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Attorney Disqualification Following *State Farm v. K.A.W.*

The Importance of Business Valuations in the Practice of Law

As we all know, the evolving complexity of the business environment has placed many daily demands on today's legal practitioner. With such complexity, specialization has become critical, both in the legal profession and in other professional disciplines. Increasingly, attorneys have relied upon specialized experts to assist them with structuring complex transactions, supporting their litigation, and advising their clients on a multitude of issues affecting their businesses.

With increasing frequency, in connection with business or tax planning transactions, and in many civil litigation proceedings, a business valuation professional may be called upon to provide assistance. The objectives of this article are to: 1) provide a brief overview of the development of the business valuation profession; 2) identify the major areas of your legal practice in which a business valuation may provide creative solutions to support transactional or litigation challenges; 3) present substantive examples when a business valuation expert can play a crucial role in the business planning and litigation processes; and 4) discuss the potential intangible benefits a business valuation may provide to the attorney.

Accordingly, it is appropriate first to define the term "business valuation." A business valuation is the act or process of arriving at an opinion or determination of the value of a business enterprise or an interest therein.¹ Such valuations are used to value an entity as a going concern, and may also be used to value the separate underlying assets of the business. The methodologies used to value a business, which are often significantly

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by Gregory F. Wilder and
Timothy K. Bronza

different from those used in real estate valuation, have developed over time such that business valuation can now be considered a separate discipline.

Overview of the Business Valuation Profession

The business valuation profession has a brief history compared to most recognized professions. The genesis of the business valuation discipline can only be traced to the 1920's, when the Board of Tax Appeals, in 1920, issued *Appeals and Review Memorandum (A.R.M.) 34* for the purpose of providing a formula for determining the amount of goodwill value lost as of March 1, 1913, (the effective date of the first federal income tax law) by breweries, distilleries, and other enterprises put out of business by Prohibi-

tion.² Subsequent to this "birth" of the profession, the Internal Revenue Service and the Treasury Department have had a major impact on the development of the business valuation discipline. In response to the estate and gift tax regulations first promulgated under the Internal Revenue Code of 1954, particularly the provisions dealing with the valuation of closely held businesses for estate and gift tax purposes, the Treasury promulgated Revenue Ruling 59-60.³ This ruling had a substantial impact on the tax profession, as it established for the first time guidelines and methodologies to be used for the valuation of closely held stocks for federal gift and estate tax purposes. Revenue Ruling 68-609 later extended the general approaches, methods, and factors listed in Revenue Ruling 59-60 so that it now applies for income and other tax purposes.⁴ These guidelines were used to support business valuations conducted for other purposes, due to the fact that the profession was unorganized and no professional practice guidelines had been promulgated up to that point in time.

The business valuation profession was not formally organized until the late 1970's and early 1980's. During this period of time several major treatises on the discipline were published and the major professional organizations were established.⁵ The growth of professional organizations has paralleled the publication of the authoritative literature on business valuation. The American Society of Appraisers (ASA) is a major, multidisciplinary appraisal organization which promulgates professional standards, develops and administers educational programs, and sponsors an annual conference specifically di-

rected at the business valuation profession. It also publishes *Business Valuation Review*, the major periodical for the profession. The ASA (accredited senior appraiser)—Business Appraisal designation is generally recognized as the preeminent designation for business appraisers, roughly equivalent to The Appraisal Institute's M.A.I. designation for real estate appraisers. The Institute of Business Appraisers, which was founded in 1978, concentrates in providing similar services and designations for its professional members.

The Major Purposes

Business valuation expertise may be important to the attorney for a number of transactional and litigation-related purposes. Various regulatory, statutory, and judicial influences either make a business valuation necessary or desirable in connection with many types of work being performed by the attorney. Following are descriptions of the many areas in which a business valuation may be useful to the attorney, either to successfully implement a transaction, or to support litigation issues arising in connection with an adversarial proceeding.

- Bankruptcy/Solvency Issues
Financial Restructuring

A business valuation may be an important resource to both the debtors' and creditors' attorneys, in order to determine whether there has been a fraudulent conveyance. The valuation may also be necessary to support elements of the reorganization plan of the debtor, whenever the valuation of a business or a segment of a business is in issue.

- *G Reorganizations (IRC §368(a)(1)(G))*

Tax-free reorganizations may be achieved under §368(a)(1)(G) of the Internal Revenue Code of 1986 by transferring substantially all of the corporate assets to another corporation in a court-directed bankruptcy procedure. A fair market value-based valuation will corroborate threshold amounts to comply with the technical reorganization provisions.⁵

- *IRC §108, Discharge of Indebtedness*

Valuation services may be necessary to substantiate the degree of insolvency of a taxpayer. The amount of insolvency is the crucial element in determining the amount of discharge of indebtedness income which may be eligible for favorable income tax treat-

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ment to the debtor. IRC §108(d)(3) defines insolvent as "the excess of liabilities over the fair market value of assets . . . immediately before the discharge." In order to determine the degree of insolvency, an appraisal should be obtained at the time of the debt discharge.⁷ This will shift the burden of proof to the government if insolvency is questioned at a later date.

- *Statement of Position (SOP) 90-7, "Fresh Start Accounting"*

Compliance requirements of SOP 90-7 may necessitate a valuation to meet accounting disclosure requirements. A valuation may be necessary for a bankruptcy court's approval of a disclosure statement. For the fresh start to apply, a company must be emerging from Ch. 11, and the shareholders of the corporation immediately before the confirmation must receive less than 50 percent of the voting stock after the plan confirmation. In addition, the value of the assets immediately before plan confirmation must be less than the amount of post-petition liabilities. In such cases, the independent appraisal will provide documentation for the preparation of new financial statements for the reorganized debtor.

- Business Combinations/Business Planning

- *Asset Acquisitions and Sales*

Purchase price allocations often can significantly reduce the tax consequences of an asset purchase. By identifying, valuing, and establishing the useful lives of the assets acquired, the amount allocated under IRC §1060 to nonamortizable assets can be mini-

mized, and the amounts allocated to depreciable assets with shorter depreciable lives can be maximized, thereby increasing and accelerating capital recovery deductions through depreciation and amortization. As supported by a recent U.S. Supreme Court case, certain intangible assets can be amortized if an ascertainable value and a limited useful life could be supported by the taxpayer.⁸ Although the recently enacted federal tax bill, known officially as the Omnibus Budget Act of 1993, now permits amortization of certain intangibles over a 15-year period under new IRC §197, proper support, including a well-documented appraisal, is still necessary to comply with the fair market value allocation provisions of IRC §1060(a). In addition, without an appraisal, it is unlikely that any taxpayer that purchases a group of intangibles can allocate tax basis to a sold intangible until the disposition of the last intangible asset. Also, the appraisal can support favorable allocations to fixed assets with shorter depreciable lives. The attorney who identifies these benefits and supports them with an appraisal can usually lower the after-tax cost of an acquisition for the client.

- *Fairness Opinions*

A business valuation may be utilized to support board of directors' decisions for proposed corporate transactions. In addition to supporting the tax requirements, a business valuation helps the board to prove that it carried out its fiduciary responsibilities, thereby lessening the likelihood of personal or corporate liability.

- *Tax-free Reorganizations*

To support the tax-free or partially tax-free status of a reorganization, a business valuation may be necessary, e.g., to support valuations and tax basis allocations for specific assets, including taxable assets (i.e., "boot") which are sold or received in the exchange.⁹

- *Net Operating Loss (NOL) and Tax Credit Carryforwards*

Corporations experiencing substantial changes in ownership may be subject to NOL and tax credit carryforward limitations under IRC §§382 and 383. Valuations at the time of the ownership change will provide support for the amount of NOL and credit carryforwards that may be utilized by the new ownership group. Built-in gains

and losses on specific assets and the overall value of the loss corporation must be determined whenever a §382 ownership change occurs.

Divestitures

An independent valuation may provide leverage for attorneys involved in negotiating sale prices, and can also support tax, accounting, and financial requirements. The attorney involved in a business divestiture should discuss the benefits of an appraisal at the first stage of preliminary negotiations. Oftentimes, the client has an unrealistic idea of the value of the business. A valuation can supplement and support the work of the attorney.

Conversion from C Corporation to S Corporation

Independent asset and/or entity valuations performed at the time of conversion from a "C corporation" to an "S corporation" will provide documentation for determining built-in gains (IRC §1374) for subsequent dispositions of corporate assets by the S corporation. The taxpayer has the burden of proof to demonstrate that the gain on the disposition of an asset is either not subject to the built-in gains tax, or that it exceeds the built-in gain at the conversion date. An appraisal is critical if there are substantial built-in gains at the date of the conversion.¹⁰

Eminent Domain (Condemnation) Proceedings

F.S. §73.071(3)(b)

Generally, established businesses affected by certain governmental property acquisitions related to eminent domain proceedings are eligible for statutory compensation for business damages caused by the acquisition. A well-documented business damage valuation is necessary to quantify the compensation due to the business.

Employee Stock Ownership Plans (ESOP)

Establishment of a New ESOP

An independent valuation of the closely held business should be one of the first steps in assessing if an ESOP is a viable financing and tax strategy tool. None of the steps necessary to determine whether an ESOP makes sense should be undertaken before the value of the business is determinable. A valuation is critical to determine whether the tax and financing benefits of an ESOP makes the most economic sense for the corporation and its shareholders. For nonpublicly traded

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employer stock acquired after 1986, all determinations of fair market value in connection with an ESOP must be based upon a valuation by an independent appraiser.¹¹

Existing ESOP's

The Internal Revenue Service and Department of Labor (DOL) regulations mandate annual independent stock valuations for ESOP's.¹² Valuations may also be required when transactions occur between the ESOP and a controlling stockholder or member of a controlled group, or if the ESOP sells out its stock position. Because of the penalties and liabilities associated with an overvaluation or undervaluation of stock, it is necessary that a well-documented appraisal be obtained.¹³

Estate and Gift Tax Planning

An independent valuation may be an integral resource to utilize in implementing effective estate planning techniques. Valuations are commonly used in conjunction with the following estate planning objectives: 1) providing liquidity for owners of closely held businesses, their heirs, or both; 2) minimization of federal gift and estate taxes associated with transfers; and 3) succession planning. Many estate and gift tax transactions can be enhanced by a business appraisal. For example, the ability to apply marketability and minority interest discounts to business interests may result in substantial tax savings to business owners who make gifts of partial interests in their business.¹⁴ In addition, valuations are frequently required to determine the fair market value of business interests

includable in the taxable estate.¹⁵

Section 6662 of the IRC imposes substantial penalties for undervaluation on the estate and gift tax return.¹⁶ A well-documented appraisal offers the greatest likelihood of avoiding a possible penalty, and enhances the likelihood that the value included on the Form 706 or Form 709 will be accepted by the IRS.

Family Law (Marital Dissolution)

Valuations related to marital dissolution may be vigorously contested. The appraisal guidelines associated with the standards of value to be used in these valuations are ambiguous, and the use of an expert who is well-versed in all the possible business valuation techniques and methodologies is critical to the success of the attorney and the client.

Oftentimes, a closely held business is the largest marital asset, and its valuation is contested by both parties to a divorce. Knowledge of the appropriate standards of value, familiarity of tax-related consequences, and proper assessment of goodwill associated with a professional practice or a closely held business are important aspects related to valuations performed for marital dissolution purposes. The attorney can greatly enhance his or her case by using an expert who is familiar with both the complex tax rules and the business valuation standards which may be applicable in a marital dissolution.

Miscellaneous Income Tax Purposes Charitable Contributions

A qualified valuation is required under the IRC §170 regulations in conjunction with a charitable contribution of nonpublicly traded stock or other property with a value of \$5,000 or more.¹⁷ Well-documented valuations are necessary in order to avoid substantial overvaluation penalties under IRC §6662, and to allow the deduction. *Tax Disputes*

A business valuation is often needed to help the attorney support various issues raised during an IRS revenue agent's reviews or disputes with other taxing authorities. Ideally, valuations should be performed at the time of the transaction to support the arm's-length nature of the deal and to avoid such future disputes. Unfortunately, in practice this is often not the case. A well-documented valuation completed by an expert can oftentimes persuade the

governmental authorities that the transaction was completed in an arm's-length manner—even if the valuation is not completed until the issue is raised upon examination.

• Intellectual and Intangible Property Valuation

Independent valuations of intellectual and intangible property such as franchises, trademarks, trade names, patents, copyrights, and customer lists are essential to enable the tax or intellectual property attorney to implement effective tax reduction strategies, both on the state and federal level. They are also frequently required to assist the attorney and the client to negotiate a sales price or a royalty rate whenever an intangible asset right is conveyed.

Because such assets are usually unique to each business and there is usually no market available to estimate the value of the intangible asset, an appraisal is a must if the value could be subject to challenge at a later date. Litigation over the value of an intangible asset conducted years after the transaction is usually the most costly and complex litigation to undertake.

• Shareholder and Buy/Sell Agreements

Valuations related to buy/sell agreements may be necessary to comply with agreement provisions regarding market-based transfers. Valuations may also be used to provide assurance to both parties involved in the transaction that the shareholder's agreement makes economic sense. These valuations should be completed annually, or at least every few years, as the value of the business will change based on profitability, economic indicators, and a number of other factors.

In addition, the value called for under the agreement must be reasonable and indicative of true fair market value, or else an IRS challenge can result in a significant unanticipated estate tax liability. *Estate of Joseph H. Lauder v. Commissioner* is a classic example of a situation where use of simplistic and convenient formulas to determine value resulted in a huge tax liability.¹⁸

Need for Experts

Traditionally, the business valuation "experts" available to support legal transactions or litigation have been professionals with very diverse back-

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grounds. Historically, business valuation experts have included certified public accountants (commonly providing services under the "litigation support" umbrella), college and university finance professors, economists, and other self-proclaimed professionals. Until recently, very few of these individuals performed business valuations on a full-time basis. As the business valuation profession has developed into a separate discipline, a common body of knowledge has evolved whereby professional course offerings and training are currently available that focus specifically on business valuation topics. Accordingly, the users of business valuation services can now rely on credible designations and courses taken by the expert, which can help to provide assurance that the professional has specific training and experience in providing such services. With today's business environment offering unprecedented challenges and opportunities, the need for a full-time professional with specific training and experience in business valuation dogma and practice is more crucial than ever. As the cases discussed below indicate, the use of a knowledgeable business appraiser can mean the difference between winning and losing, from the attorney's perspective.

As discussed, in many instances, the use of a professional that possesses specific training and experience can yield great benefits to the attorney and the client. This is particularly the case with evolving disciplines such as the business valuation profession. Because the basic theory and generally accepted

practice of the profession has developed only recently, the professionals who devote the time and effort to become schooled in this theory and practice will provide value to their clients and to attorneys because of the innovative solutions emanating from such knowledge. Use of accredited and designated individuals who devote the majority of their time to business valuations is easily cost justified.

Alternatively, those professionals who do not obtain the specific training dealing with business valuation issues will more and more frequently find themselves blindsided by the professional with superior resources and knowledge. Examples are numerous of specific cases when a business valuation professional has had a material effect on the outcome of a litigated matter. The following examples involve a number of the previously mentioned purposes for business valuations.

The potential liability of not providing any expert valuation testimony was quite evident in the very recent U.S. Supreme Court decision involving an intangible asset valuation. In *Newark Morning Ledger v. United States*, ___ U.S. ___, 113 S. Ct. 1670, 123 L. Ed. 2d 288, 61 U.S.L.W. 4313 (1993), in connection with an asset purchase, the taxpayer allocated substantial sums to various intangible assets. In this decision, the amortization of a newspaper's list of "paid subscribers" was allowed because the taxpayer presented evidence to support the fact that the subscriber list had an ascertainable value and a limited useful life. In *Newark* the Court held that "the Government presented no evidence to refute the methodology petitioner used to estimate the asset's fair market value, and the uncontroverted evidence presented at trial revealed that 'paid subscribers' had substantial value over and above that of a mere list of customers, as it was mistakenly characterized by the Government."¹⁹ The fact that the taxpayer had sought out a reputable appraisal at the time of the transaction directly resulted in \$67.8 million of tax deductions from 1977 through 1980, in addition to the interest which would have been due on the deficiency had the government prevailed. This is a prime example of a case when a contemporaneous appraisal was easily cost justified. It is important

to note that the transaction happened 17 years before the final opinion.

A decision in the Florida First District Court of Appeal also reinforces the potential hazards of not presenting competent expert valuation testimony. This decision involved the distribution of marital assets where one of the issues was the substantiation of the value of a closely held business. In *Addington v. Addington*, 522 So. 2d 897 (Fla. 1st DCA 1988), clarified on reh'g, 13 Fla. L. Weekly 903 (Fla. 1st DCA 1988), the value attributed to the appellant's insurance business had no support in the record. While the trial court may have considered the business to have some goodwill value as argued by appellee, there was no evidentiary predicate upon which such a value could be based. On the strength of the record before the court, it was only speculation as to what might have been the basis of the trial court's valuation. The only measurable basis of business valuation was the balance sheet from which a book value might be determined. That value nowhere approximated the trial court's valuation.²⁰

Expert valuation testimony was also specifically addressed in the language of the landmark Florida marital law case of *Thompson v. Thompson*, 576 So. 2d 267 (Fla. 1991). At issue was the value of an attorney's law practice at the time of the attorney's pending divorce. In *Thompson* the Florida Supreme Court found:

If a law practice has monetary value over and above its tangible assets and cases in progress which is separate and distinct from the presence and reputation of the individual attorney, then a court should consider the goodwill accumulated during the marriage as a marital asset. The determination of the existence and value of goodwill is a question of fact and should be made on a case-by-case basis with the assistance of expert testimony.²¹

In essence, a claim for goodwill as a marital asset must be substantiated by a qualified expert, preferably one with experience in the valuation of intangibles and professional practices. In another marital case involving the issue of goodwill in a professional practice in connection with a divorce, inappropriate and unconvincing business valuation evidence by one "expert" led to the court's reluctant acceptance of the other expert's testimony. Here, the lack of a credible expert who applied proper methodologies resulted in

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the court being swayed by the other experts. As the court stated:

When provable by the appropriate evidence, enterprise goodwill may be considered in valuing a spouse's professional association. In this case, however, there is no evidence upon which an appropriate valuation of enterprise goodwill may be made. We do not consider Wiggins' capitalization of future income method appropriate for valuation of professional associations for the purposes of marital dissolution proceedings. Since there have been no comparable sales and no offers to buy the practice, we find that the only proper opinion supported by competent substantial evidence was Ossi's.²²

In the tax dispute heard in *Ansan Tool and Manufacturing Company, Inc. v. Commissioner*, 63 T.C.M. 2212 (1992), the Tax Court chastised a valuation expert who did not consider the material issues regarding the valuation of the subject business. The case involved the value of a covenant not to compete, which was being amortized for tax purposes. The taxpayer used an expert who was unskilled in valuation methodologies. The result was a government victory, denying the taxpayer a deduction. Judge Goffe wrote for the court:

Based upon report and testimony, we find Mr. Schweis's valuation unreliable. There is no indication that Mr. Schweis was sufficiently familiar with petitioner's business operation to render an accurate opinion as to petitioner's worth, or the covenant's value. The above-noted flaws, coupled with unexplained "assumption" made throughout the report, require us to reject Mr. Schweis's conclusions.²³

In the estate tax case *Estate of Gladys H. Titus v. Commissioner*, 57 T.C.M. 1449 (1989),²⁴ the Tax Court rejected portions of the valuations of both the

IRS and the estate due to deficiencies in each side's testimony. The primary issue in this case was the valuation of a minority interest in a small bank holding company. Although the court's final conclusion was closely aligned with the IRS position, the introduction of cogent and credible evidence by the IRS with respect to its methodologies could have clinched a total victory for the Service.

The court determined that one valuation placed too much weight on the economic outlook and geographical location of the business, while the other valuation placed too little emphasis on these identical issues. The court cited several other precedential cases in arriving at its conclusion.²⁵ One expert may be persuasive on a particular element of valuation and another expert may be persuasive on another element. Consequently, a court can adopt some and reject other portions of expert reports or views.

Valuation experts must also be prudent insofar as the valuation approaches they use and the methodologies they employ in preparing their analysis. Using improper methodologies can result in an undesired result for the client. In a Nebraska bankruptcy proceeding, the bankruptcy court specifically noted deficiencies in the creditors' valuation testimony. As the court stated in its opinion:

The creditor presented expert testimony that the business was worth over \$30,000 at the time of the transfer. The expert based his opinion upon the capitalization of earnings of the business, and not on the asset value. The expert also did not take into consideration the market for such a business in the community, nor did it take into consideration the amount of hours worked by the debtor at the time of the transfer. Although the expert testimony should be given credence, it is not necessarily binding upon the Court. The expert valued the property as if this was a going business that could be sold to an interested party who had the capacity to operate the business, repair shoes, market the services, obtain the right to use the leasehold and work six days a week.²⁶

The court went on to state:

This Court finds as a fact that the business actually consisted of certain pieces of equipment that were worth less than \$5,000.00 and the blood, sweat and tears of the debtor. Without the debtor's personal services to the business, it was worth nothing more than the sale value of the equipment.²⁷

The case points out that the attorney

must know enough about the potential methodologies that can be used in valuing a business to determine whether his or her expert will be credible on the stand. A knowledgeable expert not only can bolster a case but also can assist the attorney by attacking the credibility of the other expert.

A well-known eminent domain case also supports the necessity to provide cogent evidence to support contentions related to business valuation-related issues. In *State of Florida Department of Transportation v. Ness Trailer Park, Inc.*, 489 So. 2d 1170 (Fla. 4th DCA 1986), *rev. den.*, 501 So. 2d 1281 (Fla. 1986), the Florida Department of Transportation (DOT) presented two arguments as justification that business damages were not available for the loss of rental income of a trailer park operation. One issue revolved around the lack of segregation between real property severance damages and business damages. The court in its opinion stated, "We believe there is no merit to DOT's arguments, for which it fails to cite authorities directly on point."²⁸

The presentation of the appropriate authoritative appraisal evidence by the expert may have had a very material effect on the outcome of the case. The DOT's failure to cite authorities directly on point may have been the result of the valuation expert's lack of properly segregating the real property interests from the business property interests, and supporting his opinion with authoritative pronouncements. The court was obviously confused by the difference between the two types of damages, as evidenced by its virtually interchangeable references to business damages and severance damages. With the introduction of such authoritative evidence, the expert may have been sufficiently persuasive to support the DOT's contentions, changing the outcome of this important case.²⁹

The classic case in support of the value of using an expert with specific valuation training and designations is *Berg v. Commissioner*, 61 T.C.M. 2949 (1991), *aff'd in part and rev'd on other grounds*, 976 F.2d 1163 (8th Cir. 1992). The salient issues of this case involved the magnitude of the minority interest and marketability discounts for a 26.92 percent interest in a real estate holding company. The case involved the

determination of the amount includable in the taxable estate.

The estate presented testimony from two experts. The first expert was described by the court as "an experienced certified public accountant" who "served as an expert witness in several cases that involved the determination of the effect of minority interest discount and lack of marketability discount. However, he has no formal education as an appraiser." The court depicted the second expert presented by the estate as "an experienced certified public accountant who served as a professor at a university" who "has no formal training as an appraiser, but has provided advisory services related to valuation of equity interests, mergers, acquisitions, leveraged buyouts, employee stock ownership plans, and litigation."³⁰

The IRS presented an expert with specific appraisal and valuation training and experience. The court characterized this expert as "a professional appraiser" who "has completed courses sponsored by the American Society of Appraisers in research and analysis of business valuations, advanced valuation, and closely held business valuation."³¹

In the court's assessment of the minority interest and marketability discounts presented by the estate, the court afforded little or no importance to either of the two appraisals submitted by the estate. With regard to the estate's first appraiser, the opinion stated, "We find the appraisal by Whalen, who is not a certified appraiser, unpersuasive for two reasons.

First, he relies on *Estate of Andrews v. Commissioner, supra*, which does not support petitioner's position. The only other support for Whalen's appraisal is two articles by H. Calvin Coolidge."

Insofar as the second appraisal was concerned, the court was similarly critical:

We attach no weight to Cobb's appraisal. His sole source of support is an unidentified study dealing with publicly announced formal transfers of ownership of a company's assets or equities. There was no such transfer of Vaberg's assets or equities as of the date of valuation. Cobb provides no analysis of the appropriate discount for minority interest with respect to the decedent's interest in Vaberg.³²

On numerous occasions, the court's opinion commended the analysis and methodologies of the IRS appraisal.³³ This resulted in a complete victory for the IRS. The court concluded:

Petitioner's appraisals, on the other hand, are exceedingly general and lacking in specific analysis of the subject interest. In addition, the expert reports submitted by the petitioner were lacking in substance and analysis. The authors of the reports were not professional appraisers, had no formal education in the valuation of business enterprises, and were not members of any professional associations involved in the education and certification of appraisers.³⁴

Conclusion

Many reasons have been mentioned to emphasize the value in using an expert with specific training and experience in business valuation in connection with the implementation of a transaction or as support for a litigated matter. First and foremost, the expert's work product may provide the



essential documentation to support a crucial transaction. A reputable appraisal generally shifts the burden of proof and makes the success of the transaction more likely. It can also decrease the likelihood of significant penalties.³⁵ Clearly, the aforementioned *Estate of Joseph H. Lauder* case demonstrates the financial liabilities involved with not obtaining an appraisal to support a transaction, with approximately \$23.7 million of additional tax liability, plus penalties and interest, incurred 18 years after the original transaction. In many cases, a properly documented business valuation may also eliminate the necessity for a prolonged and costly legal contest.

Secondly, the business valuation may provide leverage in settlement or sales negotiations.

Third, by hiring an expert to properly document and support a transaction, the attorney can avoid exposure to potential malpractice liability for failing to use a qualified expert.³⁶

Fourth, the attorney's business clients may also be able to insulate themselves from potentially millions of dollars of liability by the use of a properly documented valuation. For example, in *Charles S. Foltz, et al. v. U.S. News and World Report, et al.*, 663 F. Supp. 1494 (D.C. 1987), *aff'd*, 865 F.2d 364 (D.C. Cir. 1989), *cert. den.*, 409 U.S. 1108 (1989),³⁷ *U.S. News* was able to quell the claims of a retired employee group by prevailing on the issue of whether the ESOP shares should be valued on a minority interest basis or on a controlling interest basis. The court found that the ESOP valuation utilized by the *U.S. News* utilized the correct basis for determining the value of the ESOP shares, thus closing the door on the retirees' claims.

Finally, should litigation result, the business valuation expert may provide the necessary proficiency to bring the litigation process to a successful conclusion. All of these benefits may be obtained by the attorney and the client by hiring the professional possessing the most up-to-date training and methodologies in the rapidly maturing business valuation discipline. □

¹ AMERICAN SOCIETY OF APPRAISERS, BUSINESS VALUATION COMMITTEE, BUSINESS VALUATION STANDARD BVS-I, TERMINOLOGY (1992).

² A.R.M. 34, 1920-2 C.B. 31.

³ Rev. Rul. 59-60, 1959-1 C.B. 237. The purpose of this ruling is to outline and review in general the approaches, methods,

and factors to be considered in valuing shares of the capital stock of closely held corporations for estate and gift tax purposes.

⁴ Rev. Rul. 68-609, 1968-2 C.B. 327. In the ruling, Treasury emphasized that the "formula approach" to valuing a business should only be used when no better method is available. It also extended the principles of Rev. Rul. 59-60 to valuations conducted for all tax purposes.

⁵ The first major text on the discipline of business appraisal was G. DESMOND & R. KELLEY, BUSINESS VALUATION HANDBOOK (1977). S. PRATT, VALUING A BUSINESS (1981) became the second major authoritative text. Other definitive works which have supplemented these initial works include FINANCIAL VALUATION: BUSINESSES AND BUSINESS INTERESTS (J. Zukin & J. Mavredakis, eds., 1990), J. FISHMAN, S. PRATT, J. GRIFFITH, & D. WILSON, GUIDE TO BUSINESS VALUATIONS (1992), S. PRATT, VALUING SMALL BUSINESSES AND PROFESSIONAL PRACTICES (1993).

⁶ To qualify as a reorganization under I.R.C. §368(a)(1)(G), the transaction must meet the technical requirements of §§354, 355, or 356. In addition, the corporation may have to recognize gain or loss under §361. Under each of these sections, there are numerous instances in which a fair market valuation is required to determine if there is a gain or loss in connection with the reorganization.

⁷ See, e.g., *B.M. Marcus Estate v. Comm'r*, 34 T.C.M. 38 (1975).

⁸ *Newark Morning Ledger v. United States*, ___ U.S. ___, 113 S. Ct. 1670, 123 L. Ed. 2d 288, 61 U.S.L.W. 4313 (1993).

⁹ For example, Reg. §1.351-3(a) states that for "every person who received the stock or securities of a controlled corporation, or other property as part of the consideration" received in exchange for property under §351, they are required to file a statement with their tax return which includes the fair market value of any stock, securities, or other property received. Under §§351 and 361, any gain that needs to be recognized is determined based on the fair market value. A well-documented valuation can support the amount of gain recognized.

¹⁰ For example, Prop. Regs. §§1.1374-4(h)(4)(i) and 1.1374-7(a) indicate that the fair market values of the relevant assets must be determined at the time of conversion.

¹¹ I.R.C. §401(a)(28)(C).

¹² I.R.C. §401(a)(28)(C), ERISA §3(18), DOL Reg. §2520.103-1(b)(2), and Prop. DOL Reg. §2510.3-18(b)(3)(ii)(B).

¹³ Improper overvaluations can result in the imposition of substantial excise taxes under I.R.C. §4975(a) and (b), or potentially, plan disqualification. See, e.g., Rev. Rul. 69-494, 1969-2 C.B. 88. Undervaluations could result in violation of I.R.C. §415 limits, under Reg. §1.415-6(b)(4). Also, the ESOP trustee could be held personally liable for a violation of fiduciary duties. ERISA §§404 and 409(a).

¹⁴ See, e.g., Rev. Rul. 93-12, 1993-7 I.R.B. 13. The same principle used in the ruling can be used to support business valuation discounts in connection with more sophisti-

cated tax planning techniques. For example, substantial benefits can be attained by using family limited partnerships to make gifts to charities or family members.

¹⁵ Reg. §20.2031-1(b) states "the value of every item of property includable in a decedent's gross estate under sections 2031 through 2044 is its fair market value at the time of the decedent's death, except that if the executor elects the alternate valuation method under section 2032, it is the fair market value thereof at the date. . . ."

¹⁶ I.R.C. §6662 imposes an accuracy-related penalty to any substantial valuation misstatement on any tax return. There is a substantial valuation misstatement if the value or adjusted basis of any property claimed on a return of tax is 200 percent or more of the correct amount. (A gross valuation misstatement is 400 percent or more of the correct amount.) The penalty is 20 percent (40 percent for a gross valuation misstatement) of the portion of the underpayment attributable to the undervaluation. If the value claimed on the estate or gift tax return is 50 percent or less of the amount determined to be the correct valuation, the penalty is 20 percent of the portion attributable to the undervaluation. For valuations that are 25 percent or less of the amount determined to be correct, the penalty doubles to 40 percent because it is considered a gross valuation misstatement.

¹⁷ Reg. §1.170A-13(c).

¹⁸ *Estate of Joseph H. Lauder v. Comm'r*, 64 T.C.M. 1643 (1992). A formula price used in a shareholder agreement was not respected by the Tax Court, resulting in \$43 million of additional estate tax. Mr. Lauder was the husband of Estee Lauder of cosmetic industry fame. The court was "most concerned with the arbitrary manner in which . . . , an experienced businessman, adopted the adjusted book value formula for determining the purchase price of the stock under the agreement." No appraisal was obtained to help determine the true value of the corporate stock.

¹⁹ *Newark Morning Ledger*, 123 L. Ed. 2d 288, 294.

²⁰ *Addington v. Addington*, 522 So. 2d 897, at 898 (Fla. 1st D.C.A. 1988) *clarified on reh'g*, 13 Fla. L. Weekly 903 (Fla. 1st D.C.A. 1988).

²¹ *Thompson v. Thompson*, 576 So. 2d 267, at 270 (Fla. 1991).

²² *Spillert v. Spillert*, 564 So. 2d 1146 (Fla. 1st D.C.A. 1990).

²³ *Ansan Tool and Mfg. Co.*, 63 T.C.M. 2212, at 2221 (1992).

²⁴ The lack of a credible appraisal also resulted in an IRS victory in *Estate of Joseph Lauder v. Comm'r*, 64 T.C.M. 1643 (1992).

²⁵ See, e.g., *Silverman v. Comm'r*, 538 F.2d 927, 933 (2d. Cir. 1976) (as the opinion stated, the trier of fact is not bound by an expert's view or opinion, but may use them to assist in deciding upon a value); *Parker v. Comm'r*, 86 T.C. 547, 562 (1986); and *Helvering v. National Grocery Co.*, 304 U.S. 282 (1938).

²⁶ *Superior Industries of Neb., Inc. v. Larry D. Green*, 122 Bankr. 376, 377 (Neb. 1990).

²⁷ *Id.* at 377.

²⁸ *State of Fla. Dept. of Transp. v. Ness Trailer Park, Inc.*, 489 So. 2d. 1170, at 1181 (Fla. 4th D.C.A. 1986), *review denied*, 501 So. 2d 1281 (Fla. 1986).

²⁹ Shannon Pratt, a widely acclaimed authority on business valuation theory and practice provides advice on how to effect this segregation. "To separate the real estate value from the business value, . . . it is necessary to remove from the income statement (and in another manner from the balance sheet) all expenses associated with property ownership and to substitute a market rate of rent for the premises occupied." (S. PRATT, VALUING SMALL BUSINESSES AND PROFESSIONAL PRACTICES (1993).)

³⁰ *Berg v. Comm'r*, 61 T.C.M. 2949, at 2953 (1991), *aff'd in part and rev'd on other grounds*, 976 F.2d 1163 (8th Cir. 1992).

³¹ *Id.* at 2954.

³² *Id.* at 2957.

³³ *Id.* "Torkelson analyzes the decedent's minority interest in Vaberg in comparison to real estate investment trusts (REIT's), the publicly traded stock most similar to a privately held real estate holding company. Torkelson bases his analysis on a very

specific, comparable study published in 1988 which focuses on net asset values of REIT's. He then adjusts the findings of the study for the relevant factors of the decedent's stock in Vaberg . . . Torkelson also relies on a study based on sales of minority interests in apartment buildings. Again, he adjusts the findings of the article for the specific factors of decedent's interest in Vaberg . . . Torkelson's analysis is persuasive because he relies on very specific studies of comparable properties, and then adjusts the minority interest discount for the relevant factors of decedent's interest."

Compare this to the attack on the methodologies employed in valuing the stock in *Lauder*.

³⁴ *Id.* at 2958.

³⁵ See, e.g., *Jung Estate v. Commissioner*, 101 T.C. 28 (1993). The Tax Court held that the I.F.S. abused its discretion in not waiving the \$6660 (now \$6662) penalty for underevaluation. One of the criteria ana-

lyzed in determining whether the Service met its burden of proving that it did not abuse its discretion in failing to waive the penalty is whether the valuation claimed was not made in good faith. The court explained that the taxpayer acted in good faith by promptly retaining the services of a competent experienced appraiser. Here, but for the hiring of a competent expert, it is likely that the penalty would have been sustained.

³⁶ See, e.g., *In re Estate of Charles F. McCool*, 553 A.2d 761 (N.H. 1988). In this case, an attorney lost his estate executor and probate fees, primarily due to his lack of competence which was demonstrated by his failure to obtain a qualified business appraisal in a timely manner.

³⁷ See also *Capital City Excavating Company, Inc. v. IRS*, 47 T.C.M. 1527 (1984); and *Donovan v. Cunningham*, 716 F.2d 1455 (5th Cir. 1983), *aff'g in part*, 541 F. Supp. 276 (S.D. Tex. 1982).

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