Value Management Inc.

Issues & Updates

The Business Valuation Specialist

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How to Avoid (or Survive) an IRS Valuation Audit

The Internal Revenue Service (IRS) is cranking up its scrutiny of valuation appraisals. The IRS has recently assembled a department with over 300 in-house appraisal professionals and staff; and has obtained legal means to penalize appraisers found to be "aiding and abetting" abusive tax transactions and reporting. On the brighter side, the agency has also established a new collaborative approach for the review process, seeking early resolution of valuation issues by working directly with the taxpayer's appraiser.

Part of an Ongoing Upgrade

These recent changes have been part of a longer process to revamp review procedures. Beginning in about 2002—and in response to the general feeling among appraisers that their valuation protocols weren't receiving due deference—the IRS gathered a "review team" to reassess its standards for the profession. By 2004 it had issued its Business Valuation Guidelines, which include development, resolution, and reporting standards for use by IRS personnel.

Each of the available sets of standards from the various appraisal organizations was instrumental in developing the IRS Guidelines, including the Uniform Standards for Professional Appraisal Practice (USPAP). But the Treasury Department declined to defer to USPAP or any other, wanting the ability to amend its rules, if necessary; and to accept less-structured reports that still support values. (Notably, the IRS encourages taxpayers' appraisers to follow the standards of their respective professional organizations.)

The IRS is still working hard to achieve its goals of improving both appraisal and appraiser quality. Its current focus is threefold: (1) to develop national programs to improve professional responsibility; (2) to improve agents' adherence to the BV Guidelines; and (3) to increase the acceptability of IRS conclusions by taxpayers, internal decision makers, and the courts.

Top Five Tips for Passing IRS Review

With the IRS's current emphasis on internal and external scrutiny, what follows are the five best ways to avoid (or survive) a valuation audit:

1. *Be thorough.* Any valuation report should be self-contained, with a complete description of the appraised business or property, and a full statement and analysis of the facts. It should also provide a detailed explanation of the valuation methods with a description of the data sources used to support their value conclusion.
2. *Play IRS advocate.* Business appraisers should self-test themselves and their reports, asking the questions that the IRS appraisers would likely ask—and then they should be sure that their appraisal report has the answers.
3. *Be responsive.* If and when the IRS asks questions about the taxpayer's appraisal, the appraiser should respond with all relevant facts, valuation methods, and the sources of data that they used to support the report's conclusions.
4. *Work towards an agreement.* The taxpayer's appraiser should communicate through the taxpayer's counsel and, if permitted, directly with the IRS appraisers to identify any facts, valuation methods, models, and/or applied theories on which the parties agree. (The IRS does not expect to always reach agreement as to the results of the valuation.)

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5. *Collaborate where possible.* The taxpayer's appraiser should not be afraid to ask questions and seek clarity from the IRS.

Avoiding Valuation Traps in Court

The two most critical caveats of any valuation case are: Know thy law—and know thy law. Those are the lessons that emerged from a recent case, which focused on the valuation of an early-stage entity. The start-up company, an apparel manufacturer, had sued a supplier for allegedly "coercing" it to enter into an agreement with a textile manufacturer, which led to the loss of plaintiff's business. In its suit for damages based on the supplier's negligent misrepresentation and breach of fiduciary duty, plaintiff needed to prove the value of its lost business. The relevant timeline: The plaintiff began operations in February 1997; signed the third-party agreement on or about October 12, 1998; and closed its doors in December 1999.

First issue: Valuation Date

In cases such as these, the attorney determines the valuation date as well as the standard of value pursuant to local law. However, the appraiser should also be aware of these laws in preparing reports. In this particular matter, plaintiff's counsel chose and the expert utilized a valuation date of October 11, 1998, the day before the company signed the agreement with the third-party manufacturer. Logically, this date allowed a determination of the plaintiff's value "but for" the coerced agreement, as well as the company's resulting loss of value. Opposing counsel never challenged the valuation date, and there did not appear to be any valid, presented reason to choose another.

However, the trial court found otherwise, holding that the plaintiff's losses occurred on the date that it ceased operations in late 1999. (On review, the Court of Appeals agreed, citing local case law, prevalent in many jurisdictions, that "if a business is completely destroyed, the proper measure of damages is the market value of the business on the date of the loss.") When the trial judge issued his finding, opposing counsel quickly moved for a directed verdict and won, as there was no evidence for lost value based on the December 1999 date.

First lesson: Although it's hard to anticipate every curve ball that a court might toss—if there's any legal possibility for more than one valuation date, appraisers, in consultation with their attorneys, should consider preparing alternative valuations to avoid having the court reject their work.

Second issue: Speculative Forecasts

In rejecting the expert's report, the court also found that his reliance on forecasted future cash flows was "too speculative." But valuation often (if not always) involves some measure of a forward-looking perspective. If historical operations don't accurately indicate the future, appraisers will commonly use the discounted cash flow (DCF) method.

One challenge to any DCF is its reliance on the target's forecasted future cash flows. A careful, well-constructed and well-supported forecast is necessary for the DCF to render a meaningful valuation; for a start-up entity, the appraiser must take extra care to avoid allegations that the forecasts are "speculative."

Second lesson: Attorneys need to know, and their appraisers need to ask, whether the "new business rule" would prevent a start-up company—one that has yet to turn a profit—from proving damages for loss of its entire value. For example, in this particular case, local law held that a business can recover lost prospective profits, regardless of whether it has an established earnings record. But no case in that jurisdiction specifically addresses the recovery of lost value, and argument would rest on analogy from the lost profits case or appropriate law in other jurisdictions.

Top Valuation Questions That Lawyers Love to Ask

The list of potential "aces" that can throw experts (or their attorneys) off their courtroom game is endless. To help witnesses stay on their toes during even the most intense cross-examinations, here are a few favorite zingers—and how to lob them back with grace and style:

Q: Would *you* buy this company for what you've valued it?

A: The witness should pause for a moment, and then explain that the values stated in his/her report arise from the company's unique circumstances, taking into account the actual market conditions of what others are paying for similar companies. Moreover, business

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appraisers are not in the business of recommending what a buyer ought to pay; that decision must reflect the buyer's personal view of the market, tolerance for risk, etc.

Q: You've never actually sold a business—so you don't have a clue what *real* buyers and sellers consider, do you?

A: The answer, of course, depends on a business appraiser's actual background and experience in purchase and sales. The more common-sense understanding of buy/sell transactions the witness has, the less vulnerable he/she will be to this line of attack; make sure to rehearse responses to this question, adapted to the appraiser's particular strengths.

Q: The specific value in your report represents a range, doesn't it? If so, what is an "acceptable" range, plus or minus, and where does *your* value fall?

A: This is one of the most common "trick" questions, designed to get the witness to admit that the value is subject to adjustment within the "range." Any valuation has a subjective element; the witness can retain credibility by admitting this, and explaining what observations, analysis and other data went into the valuation, thus creating an advantage: a second opportunity to repeat direct testimony.

Q: There's a math error in your report, and that makes it *unreliable*, correct?

A: Of course, it's best to submit an error-free report. But slips happen (keep this in mind when reviewing your opponent's report). The best way to keep credibility with the judge or jury is to admit any mistake, and explain how to account for it or remedy it.

Q: Do you consider "So and So" to be an authority in business valuation?

A: Any industry, including business valuation, has its better-known, leading authorities. The trick in this question is when the attorney whips out an excerpt from this acknowledged authority which contradicts the witness's assumptions, calculations, or conclusions. But the passage will most likely be selective, out of context or out of date; and/or offer only one opinion on a subject about which reasonable experts could disagree. The latter is important, because what may have been a best practice standard years ago may no longer be relevant today, and it's appropriate to demonstrate where even a so-called "leading authority" has made a mistake or become obsolete.

Watch for Discovery Minefields During the Valuation Engagement

By nature, business appraisers tend to be careful and deliberate—real plusses in their profession, but it can create potential minefields during the discovery process. For instance, say that a client's tax return shows significant tax liability, which is factored into the overall business valuation. But then the client calls and points out that the inventory was in fact much lower. The standard BV practice is to adjust the valuation and note the file—but unfortunately, that note is now discoverable, and may make the appraiser more vulnerable on cross-examination.

In preparing their case, savvy attorneys and their appraisers should discuss these and other documents that could possibly turn against them:

- *Standard language.* Many appraisers use the first person plural in their reports, as the client hired the firm rather than the individual. Continue to use this reference in court, however, and cross-examiners will ask to whom is the "we" referring. If the expert answers by saying "my partners"—he or she will likely endure a paragraph-by-paragraph dissection of the report to eliminate what those partners may have written.
- *Web page claims.* Watch out for claims on an appraiser's web pages that say anything close to "we help attorneys win cases," as they can undermine the appraiser's credibility.
- *Checklists.* Checklists might be good for audits but litigators will question why you varied from standard procedure.
- *Cliff notes for juries.* In general, preparing summary documents of valuation opinions for juries is not a good idea. No one can teach capitalization rates in minutes; valuation witnesses will win their cases by being honest, and by convincing the judge and jury they did their work well.
- *PowerPoint vs. poster board.* Presentations disappear the moment the computer shuts down; consider using charts that will stay in front of the courtroom for the rest of the day.
- *Calendars.* An aggressive attorney could use the various meetings between lawyers and

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their experts and other professionals to dilute or discredit the experts' opinions and qualifications. In difficult trials, consider using the web site *www.gotomeeting.com,* which schedules those meetings without making records on a computer's hard disk.

VMI *HIGHLIGHTS*

Andrew Wilusz, ASA, **VMI's** Director of Mergers & Acquisitions, will be the President of the Montgomery County Estate Planning Council for the 2006-2007 Council year.

Andrew recently served as moderator for the Philadelphia Estate Planning Council's ("PEPC") Annual Seminar entitled "Viewpoints on Valuation: the Appraiser, the Attorney, the IRS and the Judge." Among the panelists were US Tax Court Judge David Laro and John Porter, Esq., from Baker Botts LLP, Houston, TX.

VMI will be a Conference Sponsor for the ESOP Association's 11th Annual Multi-State ESOP Conference to be held September 13 - 14, 2006 at the Hilton Scranton & Conference Center in Scranton, PA. In attendance will be participants from Delaware, New Jersey, New York and Pennsylvania.

VMI will be the sponsor for the PEPC's September 19, 2006 luncheon meeting entitled "Wealth Preservation Planning for Real Estate Owners and Their Families." The speaker will be Stefan Tucker, Esq., of Venable, LLP, Washington, D.C. The meeting will be held at The Union League, 140 S. Broad Street, Philadelphia, PA from 12:00 – 2:00 p.m.

Congratulations to **Joe Egler,** who recently celebrated his tenth anniversary with **Value Management Inc.** Joe is responsible for **VMI's** marital dissolution valuation practice. A Chartered Financial Analyst, Joe has performed more than 500 appraisals for **VMI**. It is not uncommon for Joe to testify a dozen or more times per year. He has also been involved in initiating, negotiating and closing transactions as an intermediary. Joe lives in Huntingdon Valley, PA with his wife, Denise, and his son, Joe.

ABOUT VALUE MANAGEMENT INC. VMI is a financial consulting firm specializing in valuing businesses, corporate securities and professional practices. Our firm is built on the performance of more than 4,000 valuations. Appraisals are rendered for estate tax planning, litigation support, and many other situations requiring independent appraisal. Our newsletter is published quarterly and does not constitute legal or financial consulting advice. It is offered as an information service to **VMI's** clients and friends. Those interested in specific guidance for legal and accounting matters should seek competent professional advice. Inquiries on specific valuation matters are welcomed.

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