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In a World of Diverse BV Standards, Credentials and Competency are Critical

The lack of unified standards has become one of the most controversial—and critical—topics for the business valuation profession. As a result, BV litigation experts may be more susceptible to intense examination regarding compliance with the appropriate professional standard(s), an area they (and their attorneys) should be prepared to expect—and use to their advantage, when cross-examining an opponent's expert.

Standards from diverse sources

Many believe that professional standards for business valuation "began" with IRS Revenue Ruling 59-60. Issued in 1959 and applicable by law to federal estate and gift tax valuations, Rev. Ruling 59-60 still remains the seminal guidance on valuation of ownership interests in closely held businesses. Its influence carried over into the BV standards that began to appear in the 1980s and 1990s: first, with The Appraisal Foundation's issuance of the Unified Standards of Professional Appraisal Practice (USPAP) in 1987, followed by standards from the American Society of Appraisers (1992), the Institute of Business Appraisers (1993), and the National Association of Certified Valuation Analysts (1993).

More recently, this past summer the American Institute of Certified Public Accountants (AICPA) issued its Statement on Standards for Valuation Services No. 1 (SSVS 1). As a result, BV professional standards are currently dispersed among five different organizations, plus continued federal guidance. The U.S. Tax Court has recognized USPAP and so has Congress, in legislation such as the Financial Institution Reform, Recovery and Enforcement Act (1989) and the 2006 Pension Protection Act. In 2006, the IRS issued Notice 2006-96, which cited USPAP as a generally accepted appraisal standard.

Multiple standards feed multiple questions

The pressure to adhere to these emerging standards is currently impacting all BV professionals, irrespective of their accrediting organizations. Beginning in January 2008, for example, when SSVS 1 became effective, many of the AICPA's approximately 300,000 members became bound by the standards when they perform valuation-related engagements.

In the litigation arena, appraisers who hold multiple credentials can expect to hear questions such as: "Which standards are best?" and "Do they ever conflict?" To maintain their credibility, experts should be prepared to answer these questions as they relate to their credentials and also their competency—that is, whether the opinions set forth in their reports comply with the appropriate standards. By the same token, accredited BV experts can help guide attorneys in developing the same questions for cross-examining their opponent's expert, identifying areas where credentials or compliance may be lacking.

Florida Court Considers Prohibiting Marketability Discounts in Divorce

Erp v. Erp, 2007 Fla. App. LEXIS 18726 (November 28, 2007)

In this case, the Florida Court of Appeals considered whether, as a matter of law, a discount for lack of marketability (DLOM) should not be applied when valuing a business for divorce purposes.

During the marriage the couple purchased an RV dealership, formed as a Subchapter S corporation, which they grew to a business that earned more than $1 million annually. Each spouse owned a 40% interest while their two children held the remaining shares equally. Prior to trial, the parties agreed that one of them should be awarded the entire 80% interest while the other spouse would receive an equalizing payment of one-half the fair market value of that interest.

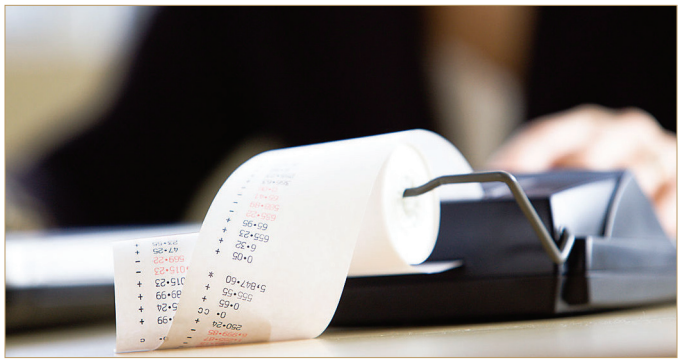
Demonstrative exhibit makes impact

At trial, both parties' experts generally used an income-based approach to value the business. The wife's expert valued the business at $12.5 million and $5 million for her 40% share. By contrast, the husband's expert valued the business at $4.56 million and the wife's one-half share at only $720,000.

However, the husband's expert presented a "demonstrative exhibit" to the trial court, which presumed to detail the differences between the two appraisals. Of particular note was the expert's application of a 25% discount for lack of marketability (DLOM).

The trial court awarded the 80% interest in the business to the husband, with an equitable distribution to the wife. The court used parts of each expert's appraisal, and ultimately valued the business at $6.2 million. Further, it valued the wife's one-half interest at $2.48 million (or 40% of the total value of the corporation).

The trial court explained its determination by reference to the demonstrative exhibit, and applied the marketability discount, but at a reduced level of 10%. Among other issues, the wife appealed the application of a marketability discount.



Should DLOMs be precluded in divorce?

The wife argued that a marketability discount should be prohibited as a matter of law in a divorce valuation. She analogized the divorce context to that of an oppressed and/or dissenting shareholder. Because a court orders judicial "buyout" in those cases (as it does in divorce), and because local (Florida) law does not permit DLOM in the oppression context, the wife argued that the court should not be permitted to apply a marketability discount in this case.

The appellate court was not persuaded. Dissenting shareholder cases arise in the context of an "involuntary change in the fundamental corporate structure," it said. The appraisal remedy protects minority shareholders who are cashed out of their investment by precluding further reduction of their interests through marketability discounts. This situation is not present in the divorce context. "What is appropriate in the oppressed shareholder or minority appraisal rights cases may not necessarily be desirable in a judicial dissolution of a corporation or in an action for dissolution of marriage involving equitable distribution."

In this case, the wife was not the victim of majority shareholder oppression. The more proper analogy, the court reasoned, is to a judicial dissolution of the business based on shareholder deadlock, where a court has discretion to determine whether a marketability discount is appropriately applied to a closely held corporation. Accordingly, the court declined to prohibit marketability discounts as a matter of law in divorce cases. Finding no abuse of discretion, it affirmed the trial court's application of a 10% DLOM.

Jelke Overruled: 11th Cir. Approves 100% Discount for Imbedded Capital Gains

Estate of Jelke v. Comm'r, 2007 U.S. App. LEXIS 26477 (November 15, 2007)

The 2005 Jelke v. Commissioner decision has been described as "poor" for the taxpayer and frustrating for the appraiser. In that case, the Tax Court declined to adopt a dollar-for-dollar discount for a holding company's built-in capital gains tax liability. On appeal two years later, the Eleventh Circuit reversed the Jelke holding, in a decision that includes a strong dissent.

A long path to 'economic reality'

The decedent in Jelke owned a minority (6.44%) interest in a closely held investment company that owned marketable securities. Citing IRS Revenue Ruling 59-60, the Eleventh Circuit found that the net asset value method was the most appropriate for valuing a stock holding company, which in turn relies on the "venerable willing buyer-willing seller test."

In addition, prior to the Tax Reform Act of 1986, courts generally did not permit a discount for built-in capital gains tax liability unless a sale or liquidation of the investment company was either planned or imminent. The discounts were deemed to be too speculative. The Tax Reform Act made "dramatic" changes, according to the Eleventh Circuit. The new law required the recognition of corporate-level gains on distributions of appreciated property. Because an individual shareholder/taxpayer would no longer receive a step-up in basis to fair market value on the valuation date (for estate tax purposes, on the date of a decedent's death), "it now became more important than ever for a taxpayer to be able to quantify his or her loss in value of the stock due to inherent capital gains tax liability in the corporation."

Reform took place more slowly in the courts. In Estate of Davis (1998), citing Rev. Ruling 59-60 and "economic reality theory," the Tax Court held that a hypothetical buyer and seller would take some account for imbedded capital gains tax. But rather than permit a separate discount, the court attributed approximately one-third of the allowed marketability discount to the contingent capital gains liability.

Further, in Estate of Eisenberg (2nd Cir. 1998) and Estate of Welch (6th Cir. 2000) the federal circuit courts concluded that a willing buyer and seller would negotiate a discount to account for the tax liability, despite no imminent liquidation or sale. But language in Eisenberg suggested that while a discount was permissible, it need not be on a dollar-for-dollar basis. Similarly, in Estate of Jameson (5th Cir. 2001), the court required consideration of imbedded capital gains liability on a 98% interest in a closely held interest that operated both a timber and an investment company. This overruled the Tax Court's decision to allow a partial discount only in relation to the planned harvests of the timber property.

Dunn ushers in new valuation era

A year later, the Fifth Circuit went a step further in Estate of Dunn (2002). The decedent owned a majority (62.2%) interest in a family corporation but lacked a supermajority, two-thirds interest that could force liquidation under local (Texas) law. Because the family also planned to keep running the company, the Tax Court approved a 5% discount for built-in capital gains, reflecting the "small" possibility that a hypothetical buyer would liquidate. But the Fifth Circuit disagreed "emphatically." A hypothetical buyer and seller must always be assumed to liquidate the corporation immediately upon the valuation date, triggering a tax on the built-in gains. The "likelihood is 100%," the court said, and the appropriate amount for the discount was equal to 100% of the capital gains liability, dollar for dollar.

"An era of valuation certainly had begun," the Jelke court observed, turning to the facts of its own case. Given the minority interest at stake and the unlikelihood of liquidation, the IRS urged the Eleventh Circuit to ratify the Tax Court's acceptance of a present value of the $51 million capital gains liability, indexed over a sixteen-year period (the likely time when the assets

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would be sold), which came to $21 million. The estate claimed this approach was both inconsistent and incomplete, given the likelihood that the value of underlying securities would change over time. It urged the application of Dunn and the certainty of a dollar-for-dollar discount—and the Court agreed.

"We are dealing with hypothetical, not strategic, willing buyers and sellers," the court said. Thus it made a threshold, "arbitrary" assumption that a liquidation takes place on the date of death, freezing all assets and liabilities at that time. Whether a majority or minority interest is present "is of no moment." Moreover, the Tax Court's present value approach was "fluidly ethereal," requiring courts to "gaze into a crystal ball, flip a coin, or at the very least, split the difference" between the respective approaches of the taxpayer and the IRS.

Majority favors precision, despite sharp dissent

"We think the approach set forth by the Fifth Circuit in [Dunn] is the better," the court held, in a two-to-one decision. By calculating the estate tax based on a "snapshot of valuation" on the date of death, the simple, logical Dunn rationale provides "practical certainty to taxpayers, appraisers and financial planners alike." It is a "welcome road map for those in the judiciary," the court added, "not formally trained in the art of valuation." The dollar-for-dollar approach also relieves courts from spending time and resources having to "wade through a myriad of divergent expert witness testimony, based on subjective conjecture and divergent opinions."

Notably, the Court declined to rule on the Tax Court's determination of discounts, finding no error in the assessment of a 15% lack of marketability discount and 10% for lack of control.

A strong dissent

Like the Dunn panel, the Jelke majority anticipated that critics in the business appraisal community might call their methodology unsophisticated and overly simplistic. In assuming this risk, it quoted the Fifth Circuit's observation in Dunn that opposite oversimplification on the methodology spectrum lies "over-engineering."

A lone dissenting judge decried the adoption of the "rule of least effort." "The majority gives in to the judicial equivalent of the doctrine of ignoble ease," the dissent wrote. The Tax Court's "real value approach" may not be perfect, and it depends on certain arguable assumptions—such as past rates of liquidation. But it produces a more accurate result than the majority's arbitrary assumption method, the dissent argued, "because it more closely reflects the economic interests of those who control the company."

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