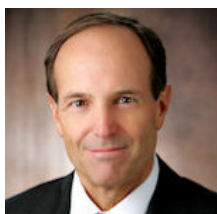


VALUATION OF A FAMILY BUSINESS INTEREST (WITH SAMPLE PROFESSIONAL SERVICES AGREEMENTS)



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These Professional Services Agreements that appear in this outline are for informational purposes only and accompanied the authors' reference outline from the ALI CLE program Estate Planning for the Family Business Owner, November 2-3, 2017. The opinions set forth in this outline are those of the presenters and not their firms or the professional associations of which they are members.

THE APPRAISER'S ROLE

The appraiser/valuation analyst plays a critical role in estate planning. Valuations from an independent, professional appraiser should be obtained early in the estate planning process. Doing so increases the taxpayer's chances that the Internal Revenue Service ("IRS" or "the Service") will not challenge the valuation and if challenged, it increases the taxpayer's chance of resolving the challenge quickly. A credible analysis also ensures that the valuation is correct, complete, and current. It will also allow the planner to get advice on what options may exist from the valuation expert's perspective early enough in the process that the planner can choose the best alternative for the client (or avoid a dead end or trap for the unwary).

THE ATTORNEY'S ROLE

The attorney's overall role is that of the navigator, or quarterback (if you prefer sports metaphors). The estate planning attorney has three initial roles with respect to valuation issues for transfer tax purposes. These are:

- Identifying valuation issues within the context of the whole estate plan – This includes both identifying hard to value assets, but also knowing what the clients want to do with these assets. It also involves knowing the current judicial and IRS positions with regard to valuation issues.
- Advising the client about the potential impacts of valuation issues – Clients may have already been

making gifts or other transfers at undocumented values (we see this frequently with annual exclusion gifts). In planning for the use of a family limited partnership, the client has to understand the necessity of running the entity in business-like fashion and documenting the actions taken within the entity.

- Obtaining the client's informed consent – Before embarking on a plan that will require annual appraisals or other formal valuation work, the attorney must get the client's understanding of what will happen, why it is desirable, and how much it will cost.

As the plan progresses toward completion and afterward, the attorney has additional roles with respect to valuation issues. These include:

- Hiring the appraiser
- Facilitating the work of the appraiser
- Reviewing the appraisal
- Submitting the appraisal
- Defending the appraisal

THE VALUATION EXPERT'S ASSISTANCE

What are the hallmarks of a valuation expert? Valuation experts provide an: (1) *independent*, (2) *professional*, and (3) *formal opinion of value* appropriate for the specific context of the subject interest and the issues involved. The three operative factors that distinguish an expert are:

- Independent – An owner can have a very good notion of the value of his or her property, but the credibility of the analysis is compromised by the personal interest of the owner. An expert is objective with no actual or appearances of conflicts of interest.
- Professional – A lay person with no formal training in the valuation of a specific item may have a very accurate feeling for the value of the property, but if they cannot articulate the basis for their opinion in the language of the relevant technical community, then they have little credibility. An expert has demonstrated knowledge and experience.
- Formal opinion of value – The valuation expert distinguishes him or herself by developing an opinion of value that takes into account all the required

factors for the specific context of the appraisal. The opinion is adequately disclosed and expressed in a format that allows the reader and the IRS to follow and understand the logic of the valuation process for the specific interest. Ultimately, this opinion has to, and can be, reconciled to what results are in the marketplace, or even to subsequent unforeseen events.

The business and intangible asset valuation expert can provide the professional legal advisor with valuable assistance during the course of a gift or estate planning in helping to:

1. Identify problem valuation situations or problem assets,
2. Identify the effects of various gift and estate planning alternatives on valuation,
3. Decide the appropriate type of report format to achieve "adequate disclosure" yet maintain a budget that makes sense with regard to the complexity and level of tax exposure of the client,
4. Decide whether to prepare a formal rebuttal report to any other expert reports submitted in opposition to the original valuation position,
5. Clarify the impact of subsequent events or newly discovered facts on the subject interest's valuation,
6. Prepare for litigation in the event an agreement cannot be achieved on audit or on appeal.

IMPORTANCE OF A CREDIBLE VALUATION REPORT

The vast majority of IRS challenges to gift and estate transfers, focus on the hard to value entities such as partnership interests or closely held corporations. The IRS claimed that more than 80 percent of the gift tax returns audited in 1999 for gifts of over \$1 million had significantly "undervalued assets" such as real estate and family business interests (The New York Times, April 2, 2000). The taxpayer generally has the burden of adequately disclosing credible evidence in order to establish the taxpayer's valuation position. Without a well-documented, complete, and thorough appraisal report, the taxpayer has no basis to dispute what may be an unrealistic IRS valuation claim upon audit.

The burden of proof shifts to the IRS, however, if the taxpayer satisfies the following conditions:

1. The taxpayer must comply with the substantiation and recordkeeping requirements of the Internal Revenue Code and regulations;
2. The taxpayer must cooperate with reasonable requests by the IRS for witnesses, information, documents, meetings, and interviews; and
3. Taxpayers other than individuals must have a net worth of less than \$7 million. (I.R.C. §7491)

The existence of a credible valuation report from a qualified appraiser can often prevent a valuation challenge. The IRS must make a cost-benefit analysis to determine whether it has a strong case against the taxpayer. A good report makes it more likely that the Service will have to expend more resources to assert its case, and will have a more difficult time trying to show that the taxpayer's position is somehow wrong. With a good report, the chances are higher that the Service will not challenge the valuation.

And if the Service does challenge the valuation report, the burden falls on the IRS to prove its case by retaining its own expert.

If the estate attorney and taxpayer decide to try to save money by not hiring an appraiser, the taxpayer risks paying a great deal more in subsequent attorney's fees, litigation expenses, higher taxes, interest expenses, and penalties. A sound valuation report is a prophylactic—it prevents and wards off IRS disputes. Bringing the expert in after the Service has challenged the taxpayer also makes it more difficult for the appraiser, particularly because the valuation may have to be performed years after the transfer took place.

Although there can be no guarantee that the appraisal will withstand the scrutiny of a Court, it puts the client in a better position to defend a challenge against discounts for lack of control and lack of marketability. Additionally, the latest version of IRS Form 709 regarding generation-skipping transfer tax issues requires the taxpayer to indicate whether a valuation discount has been applied and provide substantiation for the amount of the discount. An appraisal would supply that substantiation.

Also, a fully disclosed gift tax filing, with a qualified appraisal report attached, must be audited by the IRS within three years—or it must be accepted as filed, under the Taxpayer Relief Act of 1997 (see Chief Counsel

Advice 200221010 regarding lack of disclosure on an LLC gift, which kept the statute of limitations open).

SOME QUESTIONS TO ASK

Further below we will discuss the appropriate credentials for an appraiser of business entities or intangible assets. But a few basic questions to ask any prospective appraiser include:

- How many valuations did you (or your firm) do over the last (three) years?
- Have you previously valued interests the subject family business?
- How many of your previous engagements are similar to the subject interest in my client's case?
- What valuation credentials (or designations) do you hold? Are your credentials up to date?
- What types of training in valuation have you received? What courses have you taken?
- What articles or books have you written on the topic of valuation or similar issues?
- What speaking engagements have you made on valuation?
- What methods do you typically use in a case like this one?
- What procedural reporting guidelines do you follow in a case like this one?
- What types of databases or data services does your firm subscribe to for its valuation work?
- Have you ever had a formal complaint filed against you regarding your valuation activities?
- What sets you (or your firm) apart from other valuation practitioners?

SOME BASIC ESTATE AND GIFT VALUATION TERMS

Fair Market Value – The standard for valuing assets as set forth in Section 20.2031(estate tax) and Section 25.2512 (gift tax) of the Regulations under the Internal Revenue Code. Fair market value is the price at which the subject property would change hands between a hypothetical willing buyer and a willing seller, with both having reasonable knowledge of all relevant facts, and neither party being under any compulsion to buy

or sell. Fair market value also assumes that the price is paid all in cash or its economic equivalent at closing and the buyer is a hypothetical buyer with no specially assumed characteristics. The factors surrounding the determination of fair market value are discussed more fully in Revenue Ruling 59-60, as amended and amplified by subsequent revenue rulings and interpreted by the courts. Revenue Ruling 59-60 has been specifically extended to include the valuation of partial interests in unincorporated enterprises in Revenue Ruling 68-609.

Premise of Value – Relates to the highest and best use of the asset. The subject property is typically appraised under the premise of *value in continued use*. If the asset is a business interest, its continued use is as a *going-concern entity*. This premise of value incorporates the notion that the assets are an integral part of a going-concern business and that management's policies are consistent with arm's-length activities typical of the industry in which the entity operates. Otherwise, the premise of value may be value in an *orderly liquidation*, assuming the sale of all assets and orderly wind-down of the activities of the entity. An entity in financial distress may require a value under a *forced liquidation* assumption.

Basis of Value – Relates to the relative bundle of rights associated with the asset. For a private business interest, this can be categorized as a: (1) control interest, (2) 50 percent interest, (3) marketable minority interest, (4) nonmarketable minority interest, or (5) assignee interest. For real estate this can be categorized as: (1) fee simple interest (100%), (2) leased/leased fee interest, (3) or undivided fractional interest. The bundle of rights for each basis of value is determined by contractual agreement (such as by-laws) and state law.

Alternate Valuation Date – Section 2032 provides for the valuation of assets in the gross estate on a date other than the usual date of death. The following dates can apply:

- The date within six months of the date of death on which the property was distributed, sold, exchanged, or otherwise disposed of.
- The date six months after date of death if the property is still held by the estate.
- Note that the IRS has indicated that they will ignore internally-driven changes in the subject entity's capital structure (i.e., non-external market

changes) that occur between date of death and alternate valuation date. Their concern is that the taxpayer can manipulate the capital structure after death to lower the value of private company securities taxable in an estate.

Special Valuation Rules – There are a number of special valuation procedures that apply to special types of property or other situations that sprinkled throughout the IRC. The planner and the appraiser need to be aware of these special rules as they can supersede more conventional appraisal methods that would otherwise be applied. Or these special rules may require additional calculations of value or tax calculations that depend on various qualifying thresholds. These include:

- Land Subject to a Qualified Conservation Easement – Section 2031(c)
- Special Use Valuation for Farm/Closely Held Business Property – Section 2032A
- Qualified Family-Owned Business Interests (QFOBI) – Section 2057
- Chapter 14 – Sections 2701-2704 concern loop-hole-closing efforts by Congress in the areas of: (a) the use of grantor-retained income trusts, (b) the valuation of interests in companies with large amounts of preferred stock, (c) the treatment of options and restrictive agreements, and (d) the treatment of lapsing rights and restrictions.

Other Standards of Value – The standard for valuing assets as set forth in the Internal Revenue Code is not the only standards of value that can arise in family business valuation matters. Other standards can deviate from *Fair Market Value* under the IRC. These include:

- **Fair Value for Dissenters' Rights Proceedings** – is the price at which the subject interest would be valued if a proposed transaction or corporate action would trigger certain valuation rights under state laws.
- **Value Under Shareholder Oppression or Shareholder Derivative Actions** – also a matter of state law.
- **Fair Value for Financial Reporting Purposes** – is the value used for financial reporting purposes under GAAP (generally accepted accounting principles). Although very similar to the Fair Market

Value standard under the IRC for federal tax purposes, there are circumstances where there are differences.

- **Investment Value** – is the value to a specific buyer with individual motives that may or may not be unique to that buyer, or class of buyers. This is often the price at which your client hopes a business broker or investment banker will be able to sell the entire family business to an unrelated buyer.

SOME BASIC VALUATION CONCEPTS

The three generally accepted business valuation approaches are as follows:

1. the income approach,
2. the market approach, and
3. the asset approach.

Within each approach, there are several generally accepted business valuation methods.

A family business can be composed of segments (i.e., subsidiaries, divisions, groups of assets, or various lines of business) that may require differing valuation approaches and methods for each business segment.

THE INCOME APPROACH

The income-based approach is based on the premise that the value of the company is the present value of all the future expected economic income to be derived by the company's creditors and shareholders.

All of the different income approach methods may be broadly categorized into the following:

- Those that rely on direct capitalization
- Those that rely on yield capitalization, or discounted future returns

In a direct capitalization analysis, the analyst estimates the appropriate measure of economic income for one period (i.e., one period in the future to the valuation date) and divides that measure by an appropriate investment rate of return, or direct capitalization rate.

In a yield capitalization analysis, the analyst projects the appropriate measure of economic income for several discrete time periods into the future. The projection of the prospective economic income is converted

into a present value by the use of a present value discount rate, which is the investor's rate of return or yield rate over the expected term of the economic income projection. Specifically, the discounted cash flow (DCF) method is often used in an analysis.

THE MARKET APPROACH

There are two common methods in the market-based approach: (1) the guideline merged and acquired company (GMAC) method and (2) the guideline publicly traded company (GPTC) method.

The GPTC method is based upon a comparison of a subject company to similar "guideline" publicly traded companies. Market derived pricing multiples are developed based upon the guideline companies' financial fundamentals and quoted trading prices. The selected pricing multiples are then applied to the subject company's financial fundamentals in order to arrive at indications of value.

The GMAC method is similar to the guideline publicly traded company method in that pricing multiples are calculated and applied to a subject company. The GMAC method, however, is based upon the analysis of similar companies (either publicly traded or closely held), which have been recently acquired in a merger or acquisition transaction, as opposed to similar companies which are traded on an organized exchange. In addition, transaction pricing multiples are based on the transaction price rather than the companies' quoted trading price, and, therefore, include any price premium for ownership control.

THE ASSET APPROACH

The asset-based approach (which goes by several other names: the "asset accumulation" approach, the "net asset" approach) is based on the economic assumption that the business is worth the fair market value of its assets, less the fair market value of its liabilities.

The issues involved in developing this approach to value concern the following:

- Are we assuming the company is a going concern, or are we assuming it will be valued under the assumption of a liquidation?
- Are we assuming that the liquidation is orderly and drawn-out, or done rapidly and mainly for the benefit of creditors?

- Are the intangible assets severable from the company's existing operations and can they be marketed separately?
- Is some of value of the business tied up in the personal goodwill of the owner or other key executives, and can these values be transferred?

FINANCIAL ZOOLOGY: COMMON TYPES OF ASSETS REQUIRING APPRAISAL

One main duty of an executor/estate planner is to make the recommendation or decision to "pass it, cash it, or trash it." Assets encountered in estate and gift planning include the following categories of assets that may require an independent professional appraisal.

Tangible Assets

- Personal Property – Gems and Jewelry
- Personal Property – Art
- Personal Property – Furniture
- Personal Property – Books
- Personal Property – Precious metals
- Personal property – Collectibles
- Personal property – Possessions (clothing, automobiles, and other non-collectibles)
- Machinery and Equipment
- Real Property

Intangible Assets

- Cash and money market funds
- Publicly-traded securities (CUSIP numbered, exchange eligible)
- Private investment interests
- Intellectual property
- Other intangible assets – including digital assets

FINANCIAL ZOOLOGY: COMMON TYPES OF INVESTMENTS AND INTANGIBLE ASSET INTERESTS

• Common Stock Interests

- Minority voting stock
- Minority non-voting stock

Fifty percent of the voting common stock

Control voting stock

S-corporation common stock (including any of the categories shown above)

• General Partnership Interests

Minority general partnership interests

General partnership interests with control features

• Limited Partnership Interests¹

Minority LP interests

LP interests with various special rights: preferences or contingent rights

Limited liability limited partnerships (LLLPs)

• Limited Liability Company Membership Interests¹

Member-managed LLCs

Manager-managed LLCs

LLC interests with special rights or privileges

• Preferred Interests

Non-voting preferred interests

Voting preferred interests

Convertible preferred interests

• Debt Interests

Unsecured and secured debt interests (including AFR notes)

Fixed and variable rate debt interests (including AFR notes)

Convertible debt interests

• Intellectual Properties and Other Intangible Assets

Patents

Copyrights

Trademarks, trade names, trade dress

Trade Secrets or Specialized know-how

Digital assets - Internet web sites/urls

Rights to publicity and public image
Bitcoin, cryptocurrencies, and other blockchain-based assets
Legal and contract right claims

- **Derivatives – Options and Warrants**

Publicly traded options and warrants
Employer-provided qualified and non-qualified options
Phantom stock rights in private employer companies
Private equity investment options and warrants

- **Undivided Fractional Interests Real Estate and Other Claims**

Fractional interests with contractual agreements
Fractional interests without contractual agreements
Mining and mineral claims (including gas and oil)
Water rights
Scenic easements

THE QUALIFIED APPRAISER AND QUALIFIED APPRAISAL

Qualified Appraiser

A credible, qualified appraiser is essential when valuing difficult and complex entities. It becomes more difficult for the IRS to make the decision to challenge a valuation if a well-respected, independent analyst writes the report. And if the IRS does dispute the report, the analyst is prepared to defend it.

An experienced and qualified appraiser not only knows the various methods used to value closely held businesses but is also aware of the following areas that can add complexity to the situation:

- Current IRS rulings and Court judgments;
- Applicable issues such as the impact of a buy-sell agreement;
- Effects of state laws on asset transfers;
- Litigation procedures and rules of discoverability;

- Data on discounts for lack of marketability, blockage, and minority interests; and
- Current financial market conditions.

Besides extensive knowledge and experience, the estate planner should look for an appraiser who holds the right credentials. There are four professional associations in the U.S. and one in Canada offering education and professional credentials in the appraisal of private business interests.

The oldest association is the American Society of Appraisers, which offers the ASA (Accredited Senior Appraiser) designation. Selected other relevant organizations are:

- National Association of Certified Valuation Analysts (NACVA) – CBA, CVA
- American Institute of Certified Public Accountants (Accredited in Business Valuation – ABV)
- Canadian Institute of Chartered Business Valuators (CICBV) – CBV
- Royal Institution of Chartered Surveyors (RICS)

Another relevant accrediting organization is the CFA Institute. Its focus is primarily publicly traded securities rather than private businesses and intangible assets, but it does include certain types of “private equity” in its training programs. It awards the Chartered Financial Analyst (CFA) professional designation.

Another more recent organization is the Chartered Alternative Investment Analyst Association, which awards the Chartered Alternative Investment Analyst (CAIA) designation.

Having one or several of these designations gives the analyst creditability before the eyes of the Service and the Court. Note that merely having a CPA or an advanced business degree is not evidence of valuation competence.

Specific previous industry experience is helpful but not critical. The valuation expert should be able to identify the areas for which in-depth due diligence is needed and for which industry research, including consulting with an industry expert, will be essential.

The most widely cited and recognized set of professional standards for appraisals is the Uniform Standards

of Professional Appraisal Practice (USPAP), published by The Appraisal Foundation. USPAP is updated periodically. It covers appraisals for all disciplines, including real estate, personal property, and appraisal of businesses, business interests, and intangible assets.

The AICPA has its own set of standards titled Statement on Standards for Valuation Services (SSVS-1). All CPA-members must follow SSVS-1 when representing that they are performing a formal appraisal.

Qualified Appraisal

The IRS was not provided clear guidance on what constitutes a “qualified” appraisal report. However, IRS commentaries have indicated that a USPAP-compliant report will generally be regarded as a qualified report. The adequate disclosure rules discussed below also provide help on what is acceptable.

ADEQUATE DISCLOSURE RULES

The name of the game in gift and estate planning is “adequate disclosure.” The IRS’s rules set forth in Treasury Regulations Section 301.6501(c)-1(f)(3), published December 3, 1999, apply to all gifts made after August 5, 1997. The following requirements apply:

With Respect to the Person(s) who Prepares the Report:

1. The person must be an individual who holds himself or herself out to the public as an appraiser, or performs appraisals on a regular basis.
2. The appraiser is qualified to make appraisals of the type of property being valued.
3. The appraiser is not the donor, donee, or any employee of either, or a member of the family of any of these parties.

The Appraisal Report must contain the following information:

1. The date of the appraisal
2. The date of the transfer
3. The purpose of the appraisal
4. A description of the property
5. A description of the appraisal process employed, including the valuation method(s) utilized
6. A description of the assumptions utilized

7. A description of any hypothetical conditions considered
8. Descriptions of any restrictions or other limiting conditions present
9. The information considered in determining the value; including all financial information in sufficient detail to allow the reader to replicate the appraisal analysis and valuation
10. The reasoning that supports the analysis, opinions and conclusions
11. Any specific comparative transactions utilized in the valuation analysis
12. The fair market value of 100 percent of the entity determined without regard to any discounts in valuing the entity or the assets owned by the entity, unless this information is not relevant or material in determining the value of the interest

ADJUSTMENTS AND THEIR JUSTIFICATION

There is a wide array of adjustments that valuation experts make in the course of arriving at a fair market value. In many cases these adjustments represent the largest change in value relative to other valuation inputs such as earnings multiples or price/asset ratios.

The most important issue to keep in mind with regard to adjustments is the fact that adjustments are always measured with respect to a defined starting point. Thus, a private company stock valuation based on the earnings multiples of guideline publicly traded common stocks will not typically require a further adjustment for the relative lack of control (i.e., minority interest status) of the subject block of stock as many analysts commonly infer that publicly traded stock prices typically represent minority interest values.

Common adjustments include:

1. Adjustment for relative lack of control – minority interest
2. Adjustment for partial or complete control
3. Adjustment for temporary or permanent lack of voting rights
4. Adjustment for swing vote potential
5. Adjustment for relative lack of marketability

6. Adjustment for specific legally binding restrictions on marketability
7. Adjustment for built-in gains on asset holdings
8. Adjustment for relative uncertainties due to loss of key executive
9. Adjustment for relative uncertainties due to loss of other competitive advantages (e.g. contract or franchise rights)
10. Adjustment for exposures to regulatory and legal action (e.g. environmental remediation liabilities)
11. Adjustment for Subchapter S filing status or other pass-through entity tax status (such as partnership)

Poorly done analysis or documentation of these adjustments can result in a protracted fight with the IRS, which is always suspicious that the taxpayer is trying to “hide the ball” when reporting values.

PENALTIES APPLYING TO APPRAISERS AND ACCURACY-RELATED PENALTIES

IRC Sec. 6695A – Direct Penalties Applied to Appraisers

In September 2006 the Pension Protection Act of 2006 was signed into law. Section 1219 of the law changes appraisal requirements for tax purposes in two areas.

First, under IRC Section 170, the definitions of Qualified Appraisal and Qualified Appraiser are changed. The definition of Qualified Appraisal now refers to “generally accepted appraisal standards.” And the definition of a Qualified Appraiser now includes the term “earned an appraisal designation from recognized professional appraiser organization.” Although Section 170 relates primarily to charitable gifting, the IRS has indicated that they intend to apply these concepts to transfer tax issues in general.

Second, new IRC Section 6695A is also in force. It applies to *anyone* preparing an appraisal who knows or reasonably should have known that their appraisal would be used in connection with a tax return or claim for refund. Thus an attorney, tax preparer-CPA, or even an executor could be deemed an appraiser if they submit a valuation used “in connection” with a tax return or claim for a refund.

The penalties for such misstatements are payable by the appraiser based on the lower of two factors:

1. \$1,000 or 10 percent of the tax underpayment (whichever is greater), or
2. 125 percent of the appraisal fee. Thus, most of the time the appraiser will be exposed to a fine (i.e., a nondeductible penalty) of 125 percent of their total fee.

Section 6695A does not appear to apply to appraisals given for the purpose of existing tax litigation support, such as expert witnesses engaged after the tax return was filed.

Another provision of the Act appears to give the IRS more unilateral power to sanction appraisers for over- or under-valuations. Appraisers are now effectively held to the same criteria as attorneys and accountants for IRS practice as set forth in Circular 230. Appraisers can be—in effect—blacklisted from ever again being able to present expert testimony before the Treasury or in IRS proceedings. See Section 10.50(b). Previously, appraisers were covered under Section 6701(a) of the Internal Revenue Code, which required a higher standard of proof that the appraiser knowingly participated in an understatement of taxes.

Section 6695A effectively imposes penalties on appraisers for the taxpayer even if the appraiser did not know at the time of the appraisal that their work would result in underpayment of tax. Previously, Section 6701 only allowed the IRS to impose a penalty if the appraiser knew the appraisal would result in an underpayment of tax (i.e., active collusion). The penalty can apparently be applied even in cases in which the appraiser’s erroneous valuation is unintentional.

The penalties do not apply to appraisers who work for the IRS. As the Appeals Court observed: “This (the IRS expert’s overvaluation) exemplifies a practice of the IRS that we see with disturbingly increased frequency, e.g., a grossly exaggerated amount asserted in a notice of deficiency” (McCord, 5th Circ. 2006).

The only way to avoid the penalty is by appeal...to the Treasury Department, the same regulator imposing the penalty. The standard of appeal is based on the appraiser bearing the burden of proof that the appraised value was “more likely than not” the correct value.

The new penalties generally apply to any appraised value relating to any tax return submitted after August 17, 2006.

ACCURACY-RELATED PENALTIES

IRC Section 6662 imposes penalties on taxpayers for overstating (for income tax deduction purposes) or understating (for transfer tax purposes) valuations resulting in tax underpayments.

There are two levels of penalties: substantial understatements and gross misstatements. The nondeductible penalty for a substantial understatement is 20% of the underpayment (i.e. the amount of additional tax due when the understatement is corrected). The penalty for a gross misstatement is 40% of the understatement.

For estate and gift taxes the substantial understatement penalty comes into play when the valuation claimed on the return filed is 65% of the amount determined to be the correct amount. The gross misstatement penalty is applied when the when the valuation claimed on the return filed is 40% of the amount determined to be the correct amount. These thresholds are effective for returns filed after August 17, 2006 (as they were updated in the Pension Protection Act of 2006). For older returns, the prior thresholds were 50% for a substantial understatement and 25% for a gross misstatement.

The “correct” amount is determined either through eventual settlement between the taxpayer and the IRS or the amount finally determined by a court.

Accuracy-related penalties for income tax returns exist when the claimed value of the property is 150% of the eventually determined correct value for the substantial threshold and 200% for the gross misstatement threshold.

Regulations

The IRS issued regulations for Sections 6694 (preparers/practitioners) and 6695 (practitioners and appraisers) in late 2008.

Data Typically Requested for the Valuation

Client Data

- ___ Name of the client retaining the appraisal, including email, address and telephone number.
- ___ Legal name of the entity and identification of the interest in the entity to be valued.
- ___ Date(s) of the valuation of the subject interest.
- ___ List of names, titles and addresses/telephone numbers of the appropriate company contacts for this project.
- ___ Name, email, address and telephone number of other outside knowledgeable parties such as: Company legal counsel and accountant.

Financial Statements and Accounting

- ___ Company's financial statements for the six most recent fiscal years ending prior to valuation dates.
- ___ Federal/State income tax returns for the six most recent fiscal years prior to valuation dates
- ___ Current interim financial information for the latest period since the last fiscal year end
- ___ Interim financial information for the same period of the last fiscal year end prior to valuation date (comparison of the two interim periods allows to look at the firm on a rolling latest twelve months and year to date basis)
- ___ IRS audit correspondence or other advisory communications for the six most recent fiscal years prior to valuation date, if any
- ___ Accounting system structure, the current chart of accounts

Other Financial Data

- ___ List of equipment and depreciation schedule as of the latest fiscal year prior to valuation date.
- ___ List and description of all computer software programs used by the company; please identify any software used to run the company's financial reporting system.

- ___ Aged accounts receivable list as of latest fiscal year prior to valuation date.
- ___ Aged accounts payable list as of same date.
- ___ List of all periodic internal reports prepared for management (such reports typically include monthly sales/backlog, cash flow, status of accounts, project or production status reports, comparison to budget and expense analysis).
- ___ List of shareholders' (and any employee-family members') and officers' annual total compensation from the firm for the previous six fiscal years prior to valuation date and the interim period prior to valuation date.
- ___ Details of repayment terms of any due from officers or accounts receivable employees.
- ___ Copy of or summary of any significant equipment leases or rental agreements.
- ___ Copy of or summary of any debt instruments or credit facilities owed by the firm (such as advances, notes, mortgages, etc.).
- ___ List of any employee benefit plans and contributions made to such plans by the firm include specific contributions for each owner for the previous six fiscal years prior to valuation date.
- ___ Schedule or summary of insurance in force:
 - Life and disability
 - Property and casualty
 - Liability
- ___ Copy of any budgets prepared for firm for the three most previous fiscal years prior to valuation date. Copy of current budget.
- ___ Copies of any other projections or strategic plans or other documents prepared for internal use or for lenders or other parties within the past five years.
- ___ List of all intellectual property or intangible assets owned or controlled by the company. Copies of any patents or other documentation evidence of ownership or control.

Legal and Corporate Organization Data

- ___ List all current officers, key employees, and directors, with biographical information including: age, education, current position and prior experience.
- ___ Copies of any existing written contracts of the firm:
 - With employees
 - With customers
 - With suppliers
 - With others, particularly affiliated firms.
- ___ List of lawsuits or pending regulatory actions or litigation instituted by or against firm.
- ___ Current list of owners (including units/shares owned and total units/shares outstanding).
- ___ List of other enterprises related to the firm by common ownership or common board members, if any. List any transactions between the subject firm and these affiliated firms, officers, directors, or shareholders.
- ___ Provide a copy of the articles of incorporation, by-laws, and any amendments thereto (including current state of registration).
- ___ Payment price and terms of any large assets acquired by the company within the last six years.
- ___ Copies of Board and Shareholder meeting minutes and any materials handed out at the meetings

Marketing and Operational Data

- ___ Brief history of the firm, including how long in business and any changes in majority ownership.
- ___ Brief description of business' activities or lines of business.
- ___ Copies of marketing literature, including advertising or other media for three years prior to valuation date.
- ___ Any articles or industry information featuring or mentioning the firm, the officers or directors of the subject firm.

___ Information regarding competitors and market conditions as of the valuation date.

Real Estate and Other

___ Provide a list of real estate locations owned by the firm with:

Approximate size in square footage or acreage

Description, cost, age and approximate size of any improvements to this real estate

Current and previous usage of the real estate

Street mailing address of parcel

Copy of the real and personal property tax assessment notices for the three years prior to valuation date

Copy of any appraisals prepared for property within three years of valuation date

Copy of or summary of lease if property is rented out

___ Provide a list of real estate locations leased by the firm with:

Approximate size in square footage or acreage

Description, age and approximate size of any improvements under lease

Current usage of the real estate

Street mailing address of location

Copy of or summary of terms of the lease

HOW TO READ AND REVIEW A VALUATION REPORT

The following checklist is taken from *Valuing a Business* (Fifth Edition), Chapter 22 and sets forth the key areas to look for in any appraisal of a business interest.

The critical question to keep in mind while reading a valuation report is — “Why?”

The appraiser’s report should lead the reader through a logical path of analysis to a conclusion of value. The reasoning in the report should be supported by and based on accepted theoretical viewpoints and by empirical data. The report should explain in sufficient detail why the appraiser is relying on or selecting certain facts, assumptions, or theories as the basis for the valuation analysis.

- Identification of the subject property
- Identification of the client
- Relevant dates
- Definition of value
- Purpose of the valuation
- Ownership characteristics of the subject interest
 - Degree of control
 - Degree of marketability
- Economic outlook
- Industry outlook
- Company history and outlook
- Sources of information
- Financial statement analysis
- Valuation methodologies
 - Asset-based approach
 - Income-based approach
 - Market-based approach
- Are the data used appropriate to the valuation date?
- Valuation synthesis and conclusions
- Analyst’s qualifications and potential conflicts
- Appraisal certification
- Statement of contingent and limiting conditions
- Overall evaluation

- Conceptual problems
- Technical problems
- Calculation errors
- Typographical or inconsistency problems
- Problems with missing items

VALUATION ISSUES FROM THE COURT’S PERSPECTIVE

Supreme Court Cases

The cases below confirmed once and for all that the judges’ role as gatekeeper applies to *all* expert evidence and testimony, not just “scientific” testimony. Federal Rule of Evidence 704 requires the court to exclude any expert evidence that is not both “reliable” and “relevant.”

Daubert v. Merrell Pharmaceuticals, Inc.;²

General Electric Company et al. v. Robert K. Joiner et ux.³

Kumho Tire Company, Ltd., et al., v. Patrick Carmichael, etc., et al.⁴

In Daubert, the Court specified four tests by which to judge experts and their testimony (aka “PEAT”):

- **Peer reviews**—Has the theory been subjected to peer review or publication, which aids in determining flaws in the method?
- **Error rates**—Are there established standards to control the use of the technique?
- **Acceptability**—Is the technique generally accepted in the relevant technical community?
- **Testing**—Can the theory or technique be tested, or has it been tested?⁵

A Judge’s View on Fair Market Value and Valuation Reports

- Each valuation case is unique.⁶ Although guidance can be obtained from earlier cases, one case is rarely on point with another, and a significant differentiation of the facts can usually be made.
- In valuation there are no absolutes. There are only general guidelines to which individual judgments must be applied.
- There is no irrefutable “right” answer.
- Experts will and do differ.
- There are available methods which are generally recognized and accepted by the appraisal profession and the courts.
- A marketability discount may inhere in the value of an interest in a corporation regardless of the interest holder’s percentage ownership of the ownership stock.
- In a recent survey 65.2 percent of the Tax Court’s decisions did not coincide with the conclusions of any of the expert witnesses.
- At trial, two principal inquiries are always before the court.
 - Is the expert qualified?
 - Is the evidence to be admitted relevant and helpful?

- Always read the opinions on valuation that were written by the judge handling the case.
- Read and understand the recent opinions of the Court written by other judges on a related topic.
- Make known clearly the qualifications of the expert.
- Make special efforts to make sure that the expert’s data is highly relevant and empirical in nature.
- Make sure the expert prepares a very cogent and credible valuation report.
- If the appraisal reflects real world values and supports its conclusions with relevant empirical data about real world situations, it likely will be accepted.

A Representative Case to Read

United States Tax Court T.C. Memo 2011-148 – Estate of Louise Paxton Gallagher, Deceased, F. Gordon Spoor, Personal Representative, Petitioner v. Commissioner of Internal Revenue, Respondent

Private Business Interest: 3,970 membership interest units in Paxton Media Group, LLC (a Kentucky LLC), a 15 percent interest.

Valuation Date: July 5, 2004 (Date of Death).

Business: Newspapers, specialty publications, and a television station.

Revenues (FYE 2003): \$162.2 million, Net Income: \$42.4 million.

Original Estate Tax Return Value: \$34,936,000 (Prepared by Company’s president)

IRS Notice of Proposed Adjustment: \$49,500,000

Taxpayers Expert # 1: \$26,606,940

Taxpayers Expert # 2: \$28,200,000

IRS Outside Expert: \$40,863,000

Tax Court’s Value Decision: \$35,761,760 (via Supplemental Memorandum correcting a math error)

SAMPLE PROFESSIONAL SERVICES AGREEMENT — APPRAISER

Willamette Management Associates and Law Firm, LLP agree as follows:

1. **Description of services.** We agree to perform certain professional services for you, described briefly as follows as to purpose and objective, with the understanding that any modification to the assignment as stated below will be governed by the terms of this agreement:

Prepare an independent professional opinion of the fair market value of a noncontrolling, non-publicly marketable interest consisting of _____ (“subject interest”) of _____ (“Company”) as of _____ 201X (“subject valuation date”) for estate planning and transfer tax compliance purposes for your client(s) _____ (“Client”).

Document the facts, assumptions, and calculations supporting the conclusions of the valuation in a USPAP-compliant written appraisal report for the subject interest. The report shall be in a form that meets the “adequate disclosure” requirements set forth by the Internal Revenue Service in Treasury Regulations Section 301.6501(c)-1(f)(3) and that meets the “qualified appraisal” and “qualified appraiser” requirements set forth in Internal Revenue Code Section 170(f)(11).

2. **Date(s) services due.** We will begin performance upon receipt of all information requested of you, and will complete the assignment(s), unless delayed or prevented by matters beyond our control, according to the following schedule:

Provide a verbal briefing on the initial valuation conclusions as soon as possible after receipt of the signed agreement, retainer check and all requested data. Deliver a draft of the work product within 30 days after the verbal briefing, or as requested. Provide final draft of report immediately after review by you, or as requested.

3. **Fees.** Our fees for such professional services will be calculated on standard hourly rates in effect at the time services are rendered for staff members assigned to this project, plus out-of-pocket expenses. The fee is estimated not to exceed \$_____, exclusive of expenses such as travel, expedited delivery costs, purchases of data, copying and printing costs, and clerical time, which are estimated not to exceed \$_____. The fee will not exceed such estimate without prior notification to you.

4. **Retainer.** \$_____ is due as a retainer upon execution of this agreement. Retainer paid by you will be applied to the final billings.

5. **Payment and Other terms.** You will receive semimonthly invoices for the fees and the expenses incurred during each billing period. Payment will be due at our offices within 15 days of the date of any invoice. Invoices outstanding for more than 30 days accrue interest at the rate of 1.5 percent per month (18 percent annual percentage rate). You may arrange to have your Client pay us directly and we understand that your Client is ultimately responsible for the payment of our fees and expenses in this matter.

Additional analysis not included in this proposal will be performed at our standard hourly rates and will be done only at your request. An estimate of any additional fees and expenses for any additional work requested will be provided before proceeding with such additional analysis. Any modification to the assignment as set forth herein will be confirmed via a written communication acknowledged by both parties.

To protect our appraisal independence, and as a matter of our firm's policy, we retain the right to suspend work, and to withhold or withdraw our work product, until all outstanding invoices are brought current.

You may terminate this project at any time upon written notice to us. We will deliver a final invoice for any unpaid fees and expenses outstanding, and will refund any unapplied retainer amounts.

6. You understand that we will need prompt access to documents, materials, facilities, and/or Company personnel in order to perform our services in a timely and professional manner, and you agree to fulfill all such requests in a timely manner and to cooperate fully with us. You further understand and agree that delays in providing data or information may result in a delay of the completion date of the project.

7. We agree to perform our services in a professional and objective manner. You understand that we do not guarantee the results of any analysis which we may undertake, but only agree that any report or analysis shall represent our professional opinion based on the data given to us or compiled by us. We will attempt to obtain and compile our data from reliable sources, but we cannot guarantee its accuracy or completeness.

8. You agree to use your best efforts to provide information and data on the subject of this engagement that is materially complete and accurate to the best of your knowledge. You agree that any reports, analysis, or other documents prepared by us will be used only in conjunction with this project and in compliance with all applicable laws and regulations; and that you will hold us harmless for any breach of this warranty.

9. Both parties agree that all non-public information utilized during this engagement shall be regarded as confidential. Both parties agree to notify each other in the event any third party attempts to obtain confidential information supplied to each other, and to refrain from releasing any such confidential information except upon our mutual agreement or under valid legal process. You shall have a right of first refusal for our services regarding the subject of this engagement for a period of three years after the termination of this engagement.

10. We agree to consult with you and participate in any actions required concerning this matter after the close of this case (i.e., the date of delivery of our signed written appraisal report), including making appearances at meetings, audit conferences, or preparing work product for such appearances. In return for this continuing commitment, you agree to arrange for your Client to indemnify and hold us harmless against any and all liability, claim, loss, cost, and expense, whatever kind or nature, which we may incur, or be subject to, as a party, expert witness, witness or participant in connection with any dispute or litigation involving you on this matter unless such liability, claim, loss, cost, and expense, whatever kind or nature, is due to our wrongdoing and such wrongdoing is not caused by, related to, or the result of information provided to us by you or other parties controlled or engaged by your Client. You agree to pay (or arrange payment by your client) for all out-of-pocket expenses (including reasonable travel costs and attorney fees) and payment for all our staff members' time at standard hourly rates in effect at the time rendered to the extent we attend, prepare for, or participate in meetings, hearings, depositions, trials, and all other proceedings, including travel time. If we must bring legal action to enforce this contingent obligation, you agree to pay (or arrange payment) for all costs of such action, including any sum as the court may fix as reasonable attorney fees. This contingent obligation may be assigned to a successor party upon written notice to us signed by you and the assignee, who by signing agrees to be bound by all the terms of this agreement.

11. If this agreement, or any moneys due under the terms hereof, is placed in the hands of an attorney for collection of the account, you promise and agree to pay (or arrange payment) for our reasonable attorney fees and collection costs, plus interest at the then legal rate, whether or not any legal action is filed. If any suit or action is brought to enforce, interpret, or collect damages for the breach of this agreement, you agree to pay (or arrange payment) for our reasonable attorney fees and costs of such suit or action, including any appeal as fixed by the applicable court.

12. In the event that any provision of this agreement shall be held to be invalid, this shall not affect in any respect the validity of the other provisions of this agreement. This agreement is binding under the laws of the State of

Illinois, our firm's headquarters. This agreement shall not be deemed to be in effect, and work may not begin on this project, until we receive a signed copy of this agreement and the retainer payment from you.

Dated this _____, at Atlanta, Georgia.

Willamette Management Associates

By:

Name: Curtis R. Kimball, CFA, ASA
Managing Director

Client: LAW FIRM, LLP

By:

Print Name and Title: _____

Date:

Billing Address: _____

Telephone/facsimile: _____

SAMPLE PROFESSIONAL SERVICES AGREEMENT – KOVEL-STYLE WORDING

1. **Underlying engagement for legal services.** _____ (the “Beneficial Client”) has engaged XYZ (the “Law Firm”), to advise him regarding his estate and tax planning (the “Planning”).

2. **Scope of Services.** The Law Firm has engaged us, ABC Appraisers (“ABC”), to appraise certain assets of the Beneficial Client, as follows:

[Description of the scope of the appraisal work – development and reporting]

3. **Staffing.** ABC will assign this consultation to one or more members of our team of qualified professionals. _____ will bear ultimate responsibility for this consultation.

4. **Confidential Communications.** In the course of this engagement, we anticipate communicating both with the Law Firm and with the Beneficial Client. We will consider all such communications (the “Confidential Communications”) to be confidential and to have been made in order that the Beneficial Client might obtain legal advice from the Law Firm. Thus, we will treat all Confidential Communications as covered by the attorney-client privilege, and we will not disclose their existence, nature or content to anyone, to the maximum extent permitted by law.

5. **Confidential Writings.** In the course of this engagement, we anticipate creating or obtaining documents, correspondence, memoranda, records, working papers, notes or other material, in written form or in other media (the “Confidential Writings”). We will create and maintain files for the exclusive purpose of holding such material. We will keep all Confidential Writings, but on other material, in those files, and we will keep those files separate from all other files that we maintain. We modify our rights, under the law or professional standards governing the professional practice of accounting (or appraisal), to possess and control the Confidential Writings. Upon request at any time, we will send to the Law Firm or the Beneficial Client part or all of the Confidential Writings. We will consider all Confidential Writings to be confidential and to have been made in anticipation of litigation. Thus, we will treat all Confidential Writings as covered by the privilege for attorney work product, and we will not disclose their existence, nature or content to anyone, to the maximum extent permitted by law and professional practice standards.

6. **Exception: Compulsory process.** Notwithstanding the foregoing, if any apparently enforceable summons, subpoena or other compulsory process is served on us requiring the disclosure or production of any Confidential Communications or Confidential Writings, we will prompt the Law Firm. If the Law Firm reasonably determines that we ought to resist such disclosure or production, it will promptly inform us. Thereupon, we will engage the Law Firm, or other legal counsel reasonably acceptable to the Law Firm, to represent us in such resistance. The Law Firm and the Beneficial Client will be parties to the engagement letter governing that representation, one term of which will provide for the liability of the Beneficial Client for payment of all reasonable legal fees and related expenses incurred there under.

7. **Exception: To establish rights.** Also notwithstanding the foregoing, we may make a copy or record of any Confidential Writing to the extent necessary to establish our right to be compensated for the services we perform in the course of this engagement.

8. **Responsibility to provide information.** Both the Law Firm and the Beneficial Client will provide us promptly, completely, and to their respective best knowledge and belief, all of the information reasonably necessary to serve in this matter. That information may include relevant written material, such as statements, notes, files, tax returns, and other documents and papers. It also may include copies of any correspondence from or to the government in connection with the Planning. It also may include reasonable access to persons with relevant knowledge. Both the Law Firm and the Beneficial Client will bring to our attention any new information that reasonably might assist us in the performance of our services in this matter.

9. **Our use of supplied information.** We will presume that the information supplied to us in connection with this matter is authentic, accurate and complete. We may request, however, that any item be clarified and explained.
10. **Computation of fees and expenses.** For this engagement, we will compute our fees for rendered services on an hourly basis. Each professional person is assigned an hourly rate and records his or her time in fractions of an hour. The hourly billing rates range from _____. Because we review our billing rates from time to time, those rates are subject to change, whereupon new rates will apply to services performed thereafter. We also charge for expenditures we make in connection with the performance of services, including such expenses as photocopying, long-distance telecommunications, access to and time using computer and web-based research databases, couriers and messengers, travel and meals, and filing fees.
11. **Fee estimate.** We estimate that the Beneficial Client will incur professional fees of at approximately \$_____ in the course of this engagement. That estimate notwithstanding, the obligation to pay us for professional services rendered in the course of this engagement is neither subject to any agreed maximum amount nor contingent on the substance of any advice that we provide.
12. **Retainer.** \$_____ is due as a retainer upon execution of this agreement. [Alternative] We waive our customary requirement to pay us an amount to commence this engagement.
13. **Obligation of the Beneficial Client.** The Beneficial Client, and not the Law Firm, is obligated to pay all of the costs of this engagement.
14. **Statements; delinquency.** We will itemize all professional fees and reimbursable costs on monthly statements. Upon request, we will provide the Law Firm a duplicate copy of each statement. Statements are payable on receipt.
15. **Termination of engagement.** Any party may terminate this engagement at any time, subject to our professional responsibility to ensure that the interests of the Law Firm and of the Beneficial Client are protected in the course of any transition of service to others. The payment terms described herein, however, will survive any such termination.

FOR FURTHER READING

Business Valuation and Taxes: Procedure, Law and Perspective

David Laro and Shannon P. Pratt. (Wiley 2005)

A comprehensive resource for guidance on procedures for tax-related valuation issues (especially for estate and gift tax issues) from Judge David Laro of the US Tax Court and Shannon Pratt, business valuation expert.

Valuing a Business: The Analysis and Appraisal of Closely Held Companies, 5th Edition

Shannon P. Pratt. (McGraw-Hill 2008)

Considered a classic since its first edition over 20 years ago, the book is considered the primary reference work for business valuation. This book is used as the text book by many practitioner groups, including the American Society of Appraisers and the Federal Judicial Center.

Guide to Intangible Asset Valuation

Robert F. Reilly and Robert P. Schweihs. (AICPA 2015)

This book begins with a discussion of the basic theory of valuation, including the three approaches to value, and the process of identifying and classifying intangible assets.

PPC's Guide to Business Valuations, 23rd Edition

Shannon P. Pratt, Jay E. Fishman, J. Clifford Griffith and other contributors. (PPC 2013)

One of a number of noted reference works for valuation professionals.

Understanding Business Valuation, Fourth Edition

Gary R. Trugman. (AICPA 2012)

Another one of the noted reference works for valuation professionals, from an AICPA member.

Financial Valuation: Applications and Models, Third Edition

James R. Hitchner. (Wiley 2011)

Another one of the noted reference works for valuation professionals.

Uniform Standards of Professional Appraisal Practice (The Appraisal Foundation)

The most widely cited and recognized set of professional standards for appraisals is the Uniform Standards of Professional Appraisal Practice (USPAP), published by The Appraisal Foundation on a two-year cycle.

Notes

- 1 Note: Investments in hedge funds, private equity, and venture capital funds are typically LP or LLC interests.
- 2 *Daubert v. Merrell Pharmaceuticals, Inc.*, 509 U.S. 572 (1993).
- 3 *General Electric Company et al. v. Robert K. Joiner et ux.*, 66 U.S.L.W. 4036 (U.S. Dec. 15, 1997).
- 4 *Kumho Tire Company, Ltd., et al., v. Patrick Carmichael, etc.*, et al. 1999 WL 152455 (U.S.).
- 5 Robert F. Reilly, "Supreme Court Applies Daubert-type Screening to All Experts' Work," Shannon Pratt's Business Valuation Update, July 1999, pp. 1, 3.
- 6 Excerpted from a two-part report, "Judge Laro's Views on 'Fair Market Value,'" The Honorable David Laro, Tax Court Judge, Judges & Lawyers Business Valuation Update, May 1999, p. 1-3; and "Judge Laro's Views on Discounts & Valuation Reports," The Honorable David Laro, Tax Court Judge, Judges & Lawyers Business Valuation Update, June 1999, p. 1-4. The full text of Judge Laro's presentation is on BVLibrary.com.

CONVENIENT LOCATIONS

COMPELLING TOPICS

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