Valuation in Tax: What Non-Attorneys Should Know About Litigating Valuation Cases

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Overview

- Valuation at issue in upwards of 33% of taxpayer-represented Tax Court decisions
- Valuation routinely presented in the following types of cases:

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<td>Charitable contributions – development rights, air rights &amp; conservation easements</td>
<td>ESOPs, retirement plans, ISOSs &amp; employee compensation</td>
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<td>Formative, acquisitive &amp; divisive corporate transactions</td>
<td>Gross and substantial valuation misstatement penalties</td>
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<td>Inventory</td>
<td>Estate tax deficiencies</td>
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<td>Goodwill (personal &amp; business)</td>
<td>Gift tax deficiencies</td>
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<tr>
<td>Foreign account reporting (e.g., Form 8938, Statement of Specified Financial Assets)</td>
<td>Allocations of purchase price – I.R.C. § 1060</td>
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<tr>
<td>Collection cases (value of business and real estate reported on Forms 433-A &amp; 433-B)</td>
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Polling Question 1 – How Frequently Do You Deal With Valuation

• How often do you deal with valuation issues in your practice?
  □ Frequently
  □ Sometimes
  □ Rarely
  □ Never
Choice of Forum

• Available forums
  – Tax Court
  – District Courts
  – Court of Claims
  – Bankruptcy Courts

• Introduction to the Tax Court
  – History
  – Structure
  – Jurisdiction
Valuation in Tax Cases

• Fair market as the measure of value
  – Contrasted with market value

• Step 1: Entity valuation
  – Value property or entity as a whole, before discounts
  – Highest and best use
  – Generally without regards to subsequent events
  – For cash on commercially reasonable terms

• Step 2: Apply discounts and premiums
  – Fractional interest
  – DLOM
  – Lack of control
  – Other discounts
### Overview of the Code’s Substantiation Requirements

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<tr>
<th>Category</th>
<th>Requirement</th>
<th>Authority</th>
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<tr>
<td>Less than $250</td>
<td>Receipt or reliable written records</td>
<td>Treas. Reg. § 1.170A-13(b)(1), (2)</td>
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<td>$250 to $500</td>
<td>Contemporaneous written acknowledgment</td>
<td>I.R.C. § 170(f)(8); Treas. Reg. § 1.170A-13(f)</td>
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<tr>
<td>$501 to $5,000</td>
<td>Appraisal summary (i.e., Form 8283)</td>
<td>I.R.C. § 170(f)(11)(B)(i); Treas. Reg. § 1.170A-13(b)(3)</td>
</tr>
<tr>
<td><strong>$5,001 to $500,000</strong></td>
<td>Obtain qualified appraisal by a qualified appraiser</td>
<td>I.R.C. § 170(f)(11)(C); Treas. Reg. § 1.170A-13(c)</td>
</tr>
<tr>
<td><strong>More than $500,000</strong></td>
<td>Attach qualified appraisal by a qualified appraiser</td>
<td>I.R.C. § 170(f)(11)(D)</td>
</tr>
<tr>
<td>Quid pro quo payments of $75 or more</td>
<td>Statement of limited deduction and estimate of quid pro quo</td>
<td>I.R.C. § 6115(a)</td>
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<tr>
<td>Money (any amount)</td>
<td>Bank record or written confirmation</td>
<td>I.R.C. § 170(f)(17)</td>
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Key Qualified Appraisal Rules

- For returns filed after August 17, 2006, a deduction is not disallowed if the failure to obtain a qualified appraisal was due to reasonable cause and not to willful neglect. See I.R.C. § 170(f)(11)(A)(ii)(II).
- Recent Case Law
  - Zarlengo v. Commissioner, T.C. Memo. 2014-161 (substantial compliance doctrine used to find qualified appraisal)
  - Alli v. Commissioner, T.C. Memo. 2014-15 (neither of two appraisal reports were recognized as qualified appraisals where the reports failed the majority of the regulatory requirements)
  - Gorra v. Commissioner, T.C. Memo. 2013-254 (qualified appraisal found where the statutory and regulatory requirements were complied with)
  - Rothman v. Commissioner, T.C. Memo. 2013-163 (summary judgment not appropriate on qualified appraisal issue on account of reasonable cause)
  - Crimi v. Commissioner, T.C. Memo. 2013-51 ($2.95m deduction allowed with four year old appraisal because reasonable cause proven)
## Curing Defective Qualified Appraisals

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<th>Common Errors</th>
<th>Remedial/Preventive Measure</th>
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<td>Untimely appraisal</td>
<td>Reasonable cause post-Aug. 17, 2006</td>
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<tr>
<td>Failure to account for effect of agreements &amp; restrictions</td>
<td>Disclose and analyze all agreements &amp; restrictions affecting the property</td>
</tr>
<tr>
<td>Wrong measure of value (fair market value v. market value)</td>
<td>Counsel appraiser to invoke USPAP jurisdictional exception rule</td>
</tr>
<tr>
<td>Failure to account for fractional interest discount in before value</td>
<td>Counsel for inclusion (especially relevant in partners-level easement cases)</td>
</tr>
<tr>
<td>No reconciliation of methods</td>
<td>Include a reconciliation of methods</td>
</tr>
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Qualified Appraiser

- Appraisal designation or minimum education & experience
- Regularly performs appraisals for compensation
- Verifiable education experience
- No prohibited relationship
- Not prohibited from practice by 31 U.S.C. § 330(c)
- Required declaration
- No prohibited fee arrangement
Two competing doctrines have been developed to determine whether an appraisal is qualified:

- **Strict Compliance Doctrine:** As applied to the issue of whether a taxpayer has procured a “qualified” appraisal, the strict compliance doctrine provides that a deduction will be allowed only if the taxpayer unequivocally complies with the substantiation and recordkeeping requirements.

- **Substantial Compliance Doctrine:** The substantial compliance doctrine provides that a deduction may be allowed where the taxpayer has done all that can be reasonably expected but is still unable to comply with substantiation and recordkeeping requirements of a given internal revenue law.

Strict compliance applied in an overwhelming majority of cases:

- But see Cave Buttes, LLC v. Comm’r, 147 T.C. No. 10 (Sept. 20, 2016)
Penalties That Can Apply to Appraisers and Non-Attorneys

• I.R.C. ' 6694 penalty for preparers
  – Applies equally to appraisers
• I.R.C. ' 6695A penalty for appraisers
• I.R.C. ' 6701 penalty for aiding & abetting an understatement of tax
Audit and assessment process generally
Tips for defending an audit
Engineering Program
Concluding the Audit
  30-day letter
    Fast Track Settlement
    Fast Track Mediation
    Post-Appeals Mediation
  Notice of deficiency (i.e., the 90-day letter)
Valuation trials
Polling Question 2 –
Involving the Controversy Attorney

If your client is under audit by the IRS, when would you refer your client to a tax controversy attorney?

- At the first sign of an audit
- Before the 30-day letter
- After the 30-day letter
- Never
When do attorneys retain an expert

Selection of the expert
Tax Court (Tax Ct. R. Prac. & Proc. 143(g))

Written report must be submitted 30 days before trial

Written report is expert’s direct testimony; expert cannot testify without it

Contents of the Report

- Complete statement of all opinions and basis therefor;
- Facts or data considered by expert in forming opinions;
- Exhibits used to support opinions;
- Experts’ qualifications, including publications authored within past ten years;
- List of all cases in which the expert testified at trial or by deposition within the past four years;
- Statement of compensation.
District Courts (Fed. R. Civ. P. 26) & Court of Claims (R. Ct. Fed. Cl. 26(a)(2))

Written report exchanged as part of Rule 26 disclosures

Doctrine of variance:

Refund courts prohibit reliance on legal theories and factual bases that vary from those set forth in the administrative refund claim. See e.g., Lockheed Martin Corp. v. United States, 210 F.3d 1366 (Fed. Cir. 2000).

If refund claim is not adequately developed at the administrative level or if you expect to deviate from it in litigation, then a refund forum is ill-advised

Expert testimony excluded if not exchanged

No report at trial, but Judge may permit written report in bench trial
Under Tax Ct. R. Prac. & Proc. 70(c)(3) and Fed. R. Civ. P. 26(b)(3), draft reports and attorney-expert communications are generally privileged.

Effective date in Tax Court: June 6, 2012

Protecting Privilege

Have the attorney engage the appraiser; and

Have the attorney serve as the intermediary for all correspondence between the client and expert.

   Keep in mind that communications from client to expert will be waived if forwarded to expert or, perhaps, an accountant or enrolled agent

The Government routinely requests the instruction letter from the attorney and copies of all emails to/from the appraiser
Court-sanctioned and pretrial discovery

Service’s summons authority under I.R.C. § 7602

Ability to reach appraisals to support tax reporting position

Limitations

- Attorney-client privilege;
- Work product doctrine;
- Unfairness doctrine; and
- Draft appraisal reports and communications in connection with litigation; provided that they are between the attorney and the expert.

Taxpayers’ Rights Under I.R.C. §§ 7517, 7602, and FOIA

I.R.C. § 7517 – Requests in Estate and Gift Cases
I.R.C. § 7602(c) – Third Party Contacts
FOIA Requests, Responses, and Administrative and Judicial Review
Non-Attorneys’ Involvement During a Valuation Trial

Burden of proof on taxpayer

Shifting the burden of proof under I.R.C. § 7491

Taxpayer has the initial burden of production to come forward with credible evidence

Burden of persuasion may be shifted to Government upon such a showing

Navigating the Burden of Proof in Different Circuits

Estate of Thompson v. Commissioner, 499 F.3d 129 (2d Cir. 2007) (“Tax Court is not bound by the formulas or opinions proffered by the expert witness. It may reach a determination of value based upon its own analysis of all the evidence in the record.”)

Estate of Elkins v. Commissioner, 767 F.3d 443 (5th Cir. 2014) (Tax Court committed clear error when it did not accept taxpayer’s expert’s testimony following a failure of proof by the IRS)

Morrissey v. Commissioner, 243 F.3d 1145 (9th Cir. 2001); and Estate of Paul Mitchell v. Commissioner, 250 F.3d 696 (9th Cir. 2001) (finding a notice of deficiency arbitrary and excessive where IRS abandons value determined in that notice at trial)
What to Expect During the Case-in-Chief

Qualify the expert
   Ensure reliability and reasonableness of expert’s opinion

Satisfy Daubert
   Whether the proposed theory or technique can and has been tested;
   Whether the theory or technique has been subjected to peer review and publication;
   Whether there exists a known or potential rate of error for the theory or technique applied; and
   Whether the theory or technique has gained general acceptance in the particular filed in which it belongs.

Lay foundation for report and move into evidence

Be prepared for rigorous voir dire and cross-examination

Redirect
What to Expect on Cross-Examination

Opposing counsel will seek to clarify disputed facts and discredit the witness’ opinions, reasoning, and or data relied upon

Key areas ripe for cross-examination:

- Experience
- Bias and interest
- Bias or inconsistent position in publications
- Critically evaluate reasonableness of assumptions
- Sufficiency of data relied upon
- Scope of data relied upon
- Prior inconsistent statements
After the opposing party has cross-examined the expert, the expert should be rehabilitated.

Strategies attorneys follow for rehabilitation:

- Enable the expert to clarify his or her statements on cross-examination;
- Let the expert answer the “why” question that was avoided during cross-examination;
- Put things in context; why did the expert make the conclusions he or she did?
The Underpinnings of Concurrent Witness Testimony (Hot Tubbing)

Distrust of partisan experts

The Supreme Court observed as follows in *Winans v. New York & Erie R.R. Co.*, 62 U.S. 88 (1858):

“Experience has shown that opposite opinions of persons professing to be experts may be obtained to any amount; and it often occurs that not only many days, but even weeks, are consumed in cross-examinations, to test the skill or knowledge of such witnesses and the correctness of their opinions, wasting the time and wearying the patience of both court and jury, and perplexing, instead of elucidating, the questions involved in the issue.”

The “cottage industry” of experts

Shortcomings in the traditional adversarial process
The procedure

Six known instances in tax cases:

Rovakat, LLC v. Commissioner, T.C. Memo. 2011-225;
Crimi v. Commissioner, T.C. Memo. 2013-51;
Buyuk, LLC v. Commissioner, T.C. Memo. 2013-253;
Pohlad v. Commissioner, No. 12508-13 (T.C. June 6, 2013) (nine experts, case settled);
Exelon Corp. v. Commissioner, No. 29183-13 (T.C. Dec. 13, 2013); and
With the consent of both parties and a willing Judge

Can a Court compel the witnesses to hot tub?

Fed. R. Evid. 611(a)

The Court “should exercise reasonable control over the mode and order of examining witnesses and presenting evidence” to make the procedures effective for determining the truth and avoid wasting time

Tax Ct. R. Prac. & Proc. 131

Authorizes Court to issue orders as are necessary “to facilitate the orderly and efficient disposition” of a case calendared for trial
Fed. R. Evid. 706

“On a party’s motion or on its own, the court may order the parties to show cause why expert witnesses should not be appointed and may ask the parties to submit nominations. The court may appoint any expert that the parties agree on and any of its own choosing. But the court may only appoint someone who consents to act.”

One known instance in tax cases

Bank One Corp. v. Commissioner, 120 T.C. 174 (2003), aff’d in part, vacated in part, and remanded sub nom. J.P. Morgan Case & Co. v. Commissioner, 458 F.3d 564 (7th Cir. 2006).
Trial is not always advisable
Valuation cases are prime candidates for alternative dispute resolution

- Voluntary binding arbitration
- Voluntary nonbinding arbitration
- Mediation and settlement conferences
What was the most valuable part of today's webinar?

- Choice of forum and intro to the Tax Court
- Substantiation of charitable contributions
- Audits of valuation issues and administrative rights
- Valuation trials
Agostino & Associates, P.C. publishes a monthly journal which discusses tax, audit, and valuation issues. Would you like to be added to our mailing list?

- Yes
- No
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