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Elaine Hightower Gagliardi on Proving Estate and Gift Tax Value: Evolving Lessons from Recent Cases

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By Elaine Hightower Gagliardi[1]

§ 2.01 Introduction

The term, "fair market value," proves one of the most litigated in the Federal estate and gift tax code. Value lies in the eyes of the appraiser, often resulting in wide disparities between the Service's and taxpayer's appraised values.[2] The underlying assumptions, and at times the legal principles, on which an appraisal rests can vary greatly based on the particular asset and the appraisal method. The Tax Court claims wide latitude in deciding an asset's value, reserving the right to draw from each appraisal submitted as it deems appropriate to arrive at ultimate value based on a preponderance of the evidence. This article addresses the evolving trends in proving value as indicated by recent case law.

The positions of the Service and the taxpayer with respect to valuation depend in large part on the issue litigated. In the estate planning context the parties preferences as to value depend on whether the taxpayer's assets can be fully sheltered by the applicable exclusion amount. In a taxable estate, the taxpayer typically prefers a lower value in order to minimize estate tax payable; whereas, in a non-taxable estate, the taxpayer may prefer a higher value, especially with respect to depreciable assets, in order to obtain an increased basis. In each case the Commissioner likely will take the opposite position. The consistent tension between the Service and taxpayer as to valuation yields numerous cases each year. The recent cases discussed in this article involve taxable estates or gifts where the Commissioner's appraisal yields a higher asserted value than that of the taxpayer's appraisal.

The determination of value can have a substantial impact on the amount of tax ultimately paid and whether the court may assess a penalty for undervaluation. Analysis of recent cases provides a better understanding of trends in proving valuation. Following in Part II, the article examines how the burden of proof, and the potential for shifting that burden to the Commissioner, often has little or no impact on the Tax Court's ultimate determination of value. Part III focuses on trends in application of the willing buyer – willing seller test, specifically adjustments for personal goodwill, fractional interests and built-in capital gains. Part IV concludes that the common thread to prevailing in a valuation case is the importance of providing a strong factual basis for each key assumption underlying the ultimate determination of value. The cases reveal that, in general, it is only when one party provides no evidence of value does the court adopt in full the appraisal

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[2] *See, e.g.*, Est. of Giovacchini v. Comm'r, TC Memo. 2013-27 (taxpayer's appraisal asserted $7.4 million value and Service's over $25 million).

submitted by the opposing party, otherwise application of the preponderance of evidence standard in valuation cases leads to the Tax Court picking and choosing among various assumptions to arrive at a compromise value. The tendency of the court to pick and choose among assumptions and theories of the different appraisals encourages both parties to litigate.

§ 2.02 Trends in Application of the Burden of Proof: Applying the Preponderance of Evidence Standard

Taxpayers generally bear the burden of proving value, however, by presenting credible evidence and meeting certain other requirements, a taxpayer can shift the burden of proof to the Commissioner of the Internal Revenue Service.[3] The consistent theme running through recent opinions is a simple, and one would think obvious, one -- that it is important to submit some evidence or to stipulate to facts supporting each of the key assumptions on which a party's appraisal rests regardless of who bears the burden of proof. The corollary theme is that courts should premise any determination of value on such evidence. Despite the elemental nature of providing an evidentiary basis for each finding, recent court opinions reveal that both the parties and the Tax Court have on occasion detrimentally ignored its importance in questions of value. Recent cases highlight that a lack of evidence in the record and inattention to detail in the appraisal or in the submission of testimony can cause the court to arrive at a value favoring the other party. Current appellate court opinions also take issue with the manner in which the Tax Court employs the preponderance of evidence standard admonishing that any determination of value must be grounded on facts substantiated by the evidence and not on conjecture as to assumptions and facts not supported by the evidence. Both criticisms rest in application of the burden of proof in valuation cases.

Valuation includes questions of fact, as well as questions of law.[4] As to questions of fact, the taxpayer can shift the burden of proof to the Service by presenting credible evidence and meeting certain other requirements of I.R.C. Section 7491.[5] Absent a shift of the burden of proof under I.R.C. Section 7491 or other provision, the taxpayer bears the burden of proving facts necessary to support a particular estate or gift tax value. Nevertheless, the Tax Court in arriving at value at times brushes aside the issue of which party bears the burden of proof explaining it is unnecessary to address burden of proof as its decision is based on a preponderance of the evidence.[6] The Tax Court opinions explain that the issue of who bears the burden of proof becomes irrelevant when both parties produce credible evidence on the issue of valuation.[7] By admitting into evidence an appraisal by a qualified expert, the party bearing the burden of proof can meet its initial burden.

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[3] Tax Court Rule 142; IRC § 7491.
[4] Kaufman v. Comm'r, TC 2014-52 (*citing* US v. Woods, 134 S Ct 557, 2013 US LEXIS 8776 (US 2013)).
[5] IRC § 7491.
[6] See Est of Richmond v. Comm'r, TC Memo. 2014-26 at 21-22 (*citing* Helvering v. Nat'l Grocery Co., 304 US. 282, 295 (1938); Estate of Newhouse v. Comm'r, 94 TC 193, 217; Parker v. Comm'r, 86 TC 547, 562 (1986); Buffalo Tool & Die Mfg. Co. v. Commissioner, 74 TC 441, 452 (1980); Estate of Heck v. Comm'r, TC Memo 2002-34).
[7] *Id*.

When both parties submit such proof, the Tax Court, relying on the preponderance of the evidence standard, normally picks and chooses among various assumptions provided in the appraisals and expert testimony in order to arrive at its own assessment of valuation, most often reaching a middle ground between the two appraisals. Only where one party fails to submit any credible evidence making the preponderance of evidence standard inapplicable does the determination of who bears the burden of proof become of note. Appellate court decisions have found fault with the Tax Court's application of the preponderance of evidence standard, as well as its tendency to refrain from indicating which of the parties bears the burden of proof.

[1] Meeting the Burden of Proof

Current cases reinforce that in the final analysis it may matter very little whether it is the taxpayer or the Service charged with the initial burden of proof. Instead, what matters is whether a party in fact submits proof on which the Tax Court can rely to make its determination of value. Upon submission of credible evidence the court in employing the preponderance of evidence standard will exercise latitude in assigning a value. In two recent cases, one where taxpayer bore the initial burden of proof, *Tanenblatt v. Commissioner*,[8] and a second where the circuit court indicated the Service should have born the burden of proof, *Elkins v. Commissioner*,[9] did a failure to provide proof by the party bearing such burden result in a holding wholly in favor of the other party. In other cases the Tax Court in applying the preponderance of evidence standard normally picks and chooses among portions of the parties' appraisals to arrive at a mid-range value.

It is only when the taxpayer fails to present credible evidence that assignment of the burden of proof in fact impacts the Tax Court's determination of an asset's value. Without elaborating, the Tax Court in *Tanenblatt v. Commissioner*[10] assigned the burden of proof to taxpayer in a case addressing the value of a 16.667 percent interest in a limited liability company holding commercial real estate. In *Tanenblatt*, the taxpayer obtained an appraisal to document value as reported on the estate tax return. The appraisal attached to the estate tax return applied discounts for minority interest of 35 percent and lack of marketability of 20 percent based on net asset value. The Service accepted the value as reported on the return, but disputed the discounts taken asserting 20 percent and 10 percent discounts, respectively. In its Tax Court petition, taxpayer asserted a value lower than that reported on the estate tax return by attaching an appraisal to its Tax Court petition, but at trial the appraiser refused to appear in court because of a fee dispute with the taxpayer. The court, thus, determined the taxpayer's appraisal was not properly admitted into evidence, and provided as part of its opinion a detailed explanation of steps the taxpayer should have taken to admit the appraisal into evidence, but which the taxpayer failed to do. As a consequence, the Tax Court based its determination of value entirely upon the appraisal submitted by the Commissioner, which was the only appraisal before it. By failing to submit any credible evidence as to value, taxpayer left the court with only one appraisal from which to derive value. Had the taxpayer submitted credible evidence, the Tax Court would likely have evaluated the appraisals pursuant to a preponderance of evidence standard and arrived at a compromise value more in favor of the taxpayer's position.

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[8] Tanenblatt v. Comm'r, TC Memo. 2013-263.

[9] Est. of Elkins v. Comm'r, 140 TC 86 (2013), *aff'd in part and rev'd in part*, 767 F3d 443 (5th Cir. 2014)

[10] *Tanenblatt*, TC Memo 2013-263.

Similarly, the Fifth Circuit in *Estate of Elkins v. Commissioner*,[11] reminded the Tax Court that absent submission of credible evidence of value by one party, the court has no option but to adopt the value indicated in the appraisal of the other party. In reviewing the Tax Court's determination of value, the Fifth Circuit in *Elkins* rejected the Tax Court's determination of value in part on the basis that the Tax Court reached a value not supported by the evidence after applying the preponderance of the evidence standard.[12] The appellate court admonished the Tax Court that when applying a preponderance of the evidence standard the court's ultimate finding must be supported by evidence. In reversing the Tax Court, the *Elkins* appellate opinion began by criticizing the Tax Court for failing to shift the burden of proof to the Commissioner. The Fifth Circuit pointed out:

> The Tax Court failed to require the Commissioner to bear that burden of proof, even though 26 U.S.C. § 7491 mandates that when, as here, the petitioning taxpayer adduces sufficient evidence to establish the material facts—in this case, the amounts of the discounts—the Commissioner has the burden of refuting such facts and proving different ones.[13]

Noting that the Service failed to proffer any evidence on the appropriate discount to apply to the artwork in contrast to the taxpayer's submission of credible evidence as to appropriate discounts, the Fifth Circuit indicated: "Under a proper administration of § 7491's burden of proof rule, this case should have ended at that point with a judgment for the Estate."[14]

The *Elkins* and *Tanenblatt* opinions emphasize the necessity of submitting an appraisal indicating value. The *Elkins* opinion stresses that once the taxpayer has produced credible evidence, the Commissioner must refute that evidence to succeed in achieving a value higher than that asserted by the taxpayer.[15] Likewise, the Tax Court's opinion in *Tanenblatt* indicates a similar result. In *Tanenblatt* the Tax Court specified the burden of proof remained with the taxpayer, and in light of a lack of any evidence by the taxpayer refuting the appraisal submitted into evidence by the Commissioner, the Tax Court adopted the value indicated in the Commissioner's appraisal.[16] The lesson from these recent cases is a basic one that the cost of a well-prepared appraisal proves an absolute necessity if the party wishes to meet its burden of proof and persuade the court to adopt a value for the asset other than the value propounded by the opposing party.

[2] "Picking and Choosing" from Appraisals to Arrive at Value

In decisions where the Tax Court's finding of value rests on a preponderance of the evidence, both the Service and the taxpayer typically have submitted appraisals by experts into evidence. The Tax

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[11] Est. of Elkins v. Comm'r, 767 F3d 443 (5th Cir 2014), *affirming in part and reversing in part,* 140 TC 86 (2013).
[12] *Id.*
[13] Est. of Elkins, 767 F3d at 449.
[14] *Id.*
[15] *Id.*
[16] Tanenblatt, TC Memo. 2013-263.

Court in applying the standard makes clear that it is not required to choose between the two appraisals, but may draw its conclusions broadly from all evidence submitted and on which the appraisals rest. Specifically, the court enunciates:

> [W]e are not bound by the opinion of any expert witness and may accept or reject such testimony in the exercise of our sound judgment. [Citations omitted.] Although we may accept an expert's opinion in its entirety, we may instead select what portions of the opinion, if any, to accept. [Citations omitted.] Because valuation involves an approximation, the figure at which we arrive need not be directly traceable to specific testimony if it is within the range of values that may be properly derived from consideration of all the evidence.[17]

It is this last quoted sentence that the circuit courts have found troublesome in evaluating the Tax Court's application of the preponderance of the evidence standard. Recent appellate court decisions underscore the necessity of tracing the court's findings to specific testimony, although not necessarily a specific value. Those opinions, however, do not quibble with the Tax Court's ability to pick and choose from the theories and assumptions of the appraisals and expert testimony for which there is ample support in the evidence before the court.

The court's analysis of the appraisals submitted into evidence by both the taxpayer and Commissioner most often leads to acceptance of portions of each appraiser's opinion as opposed to the appraisal in its entirety, whether it is adoption of the particular method of valuation used, the discount rate and other assumptions made in applying the method of valuation, or the choice of applicable discounts or determination of the amount of the discount.[18] For example, in determining the value of stock in a family investment company in *Estate of Richmond v. Commissioner*,[19] the Tax Court relied in part on each appraisal, using a net asset valuation method and the method of determining built-in capital gains discount as adopted by the Service's appraisal, and minority and lack of marketability discounts similar to, but not specifically, those applied by the taxpayer's expert. Not surprisingly, the *Richmond* court settled the dispute at the proverbial middle ground. The Service's expert asserted a value of $7,330,000 and the taxpayer's a value of $5,046,500, with the court determining a mid-range value of $6,503,804. Reliance on the preponderance of evidence standard, which allows the court to pick and choose from the specific assumptions and assertions of the appraisals, yields values somewhere in the range between those asserted by the Service and by the taxpayer.[20]

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[17] Est of Richmond v. Comm'r, TC Memo. 2014-26 at 21-22 (*citing* Helvering v. Nat'l Grocery Co., 304 US 282, 295 (1938); Estate of Newhouse v. Comm'r, 94 TC 193, 217; Parker v. Comm'r, 86 T.C. 547, 562 (1986); Buffalo Tool & Die Mfg. Co. v. Comm'r, 74 TC 441, 452 (1980); Estate of Heck v. Comm'r, TC Memo 2002-34.
[18] Est of Richmond, TC Memo 2014-26.
[19] *Id.*
[20] *Id.*

Again, in *Giovacchini v. Commissioner*[21] a case in which the Service bore the burden of proof, the Tax Court nevertheless arrived at a compromise value as between the disparate amounts asserted by the parties. Initially the parties were more than $28 million apart with regards to estate tax value, and more than $17 million apart on gift tax value.[22] In *Giovacchini*, the court prefaced its analysis by indicating that when the burden has shifted, the court must "determine how to weigh"[23] the evidence. The Tax Court acknowledged that "[a]t best, evidence of value is largely a matter of opinion,"[24] and again reserved the ability to "accept or reject an expert opinion in full or in part in the exercise of sound judgment"[25] and also to "reach a determination of value based on [its] own examination of the evidence in the record."[26] In valuing an unusually large parcel of real property, the court found fault with both the appraisal submitted by the Service and the one submitted by the estate at trial choosing to rely on neither appraisal. It instead used as a starting point the subsequent sales price for the property negotiated by the estate and a conservation organization acting as a middleman for an eventual transfer to the United States Department of Agriculture. The court pointed out that the appraisal submitted by the Service's expert at trial indicated a value less than the sale price, and after considering testimony of several experts for the estate who found flaws with the Service's appraisal, the court adjusted the negotiated purchase price downward by 40 percent. By determining that it was not duty bound to adopt an appraisal in full, the court arrived at a compromise value.

The lesson to be observed from an analysis of the Tax Court's application of the preponderance of the evidence standard explains why the valuation issue lies at the heart of so many estate and gift tax cases before the court each year. Although the court acknowledges it may choose to adopt the value arrived at in an appraisal in whole, it rarely does so. By picking and choosing from the various appraisals and expert testimony before it, the taxpayer knows practically that in litigating value it will end up with a better result than that assessed by the Service. If instead the court were to exercise the discretion it has to adopt an appraisal of one party or the other in whole cloth, the risk of not having the winning appraisal would encourage an earlier resolution of the valuation issue and likely more tempered appraisal positions.

[3] Tracing Findings of Value to Evidence Submitted

Recent case law clarifies that the Tax Court's determination of value must derive from evidence admitted at trial. These cases rein in and give definition to the Tax Court's broadly claimed right that the court's determination of value "need not be directly traceable to specific testimony if it is within the range of values that may be properly derived from consideration of all the evidence."[27]

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[21] Giovacchini v. Comm'r, T.C. Memo. 2013-27.
[22] *Id.*
[23] *Id.* at 36-37.
[24] *Id.* at 49.
[25] *Id.* at 36.
[26] *Id.* at 37.
[27] Est of Richmond, TC Memo 2014-26 at 21-22.

This assertion of discretion has led the Tax Court at times to arrive at a value that does not find any support in evidence admitted at trial like it did in *Elkins v. Commissioner*[28] when the court adopted a discount different and lower than that asserted in the taxpayer's appraisal even though the Commissioner failed to submit any evidence to the contrary. At other times, and in contrast, as in *Tanenblatt v. Commissioner*,[29] the Tax Court has chosen to rely solely on admitted evidence, refusing to adopt a value different than set forth in the sole appraisal before it. The variations among Tax Court opinions have caused the appellate courts to remind the Tax Court that its determination of value must indeed find support in the evidence before the court.[30]

In reversing the Tax Court, the Fifth Circuit *Elkins* decision makes clear that each party must produce at least some evidence of value in order for the Tax Court to arrive at a compromise value between that asserted by Commissioner and that by taxpayer.[31] It further holds that in the event only one party provides evidence of value on a particular point or issue as in *Elkins*, that party's appraisal, if credible, must form the basis for the court's determination of value as to that issue.[32] In other words, the Tax Court simply may not arrive at a value for which no evidence has been submitted as it did in *Elkins*. In *Elkins*, taxpayer submitted an appraisal documenting substantial discounts for fractional interests in artwork, and testimony of more than one expert as to the appropriateness of those discounts. The Commissioner, on the other hand, took a bright line stance that discounts are not appropriate and failed to submit any evidence to substantiate a discount lower than that set forth by taxpayer. The Tax Court held that a discount was appropriate in valuing fractional interests in art, but determined a discount less than that asserted by taxpayer despite a lack of evidence in the record for a lower discount. The Fifth Circuit reversed and directed a discount equal to that documented in the taxpayer's appraisal as it was the only appraisal before it.[33] The Fifth Circuit holding limits the Tax Court's ability to arrive at a compromise value not traceable to evidence submitted in support of the finding of value.

More revealing is the analysis of the Ninth Circuit in an unpublished opinion reversing the Tax Court's holding in *Estate of Giustina v. Commissioner*[34] and indicating that in applying the preponderance of the evidence standard, the Tax Court must rely on evidence in fact in the record. The Ninth Circuit questioned whether the Tax Court's finding of a 25 percent probability that the underlying entity would dissolve found any basis in the evidence, or whether its determination relied on "imaginary scenarios."[35] The taxpayer's appraiser testified that a hypothetical buyer could "not unilaterally force a sale of the partnership."[36] To arrive at a different conclusion, the Tax Court

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[28] Est. of Elkins, 140 TC 86 (2013).
[29] Tanenblatt, TC Memo 2013-263.
[30] Est. of Elkins v. Comm'r, 767 F3d 443 (5th Cir 2014), *affirming in part and reversing in part,* 140 TC 86 (2013); Est. of Giustina v. Comm'r, 2014 US App LEXIS 22961 (9th Cir 2014), *reversing* TC Memo 2011-141.
[31] Est. of Elkins, 767 F3d at 450.
[32] *Id.* at 453.
[33] *Id.*
[34] Est. of Giustina v. Comm'r, 2014 US App LEXIS 22961 (9th Cir 2014).
[35] *Id.* at 3.
[36] Est. of Guistina v. Comm'r, TC Memo 2011-141at 22-23.

hypothesized various ways a buyer could join with others to cause a sale. With regard to yet a different finding in *Giustina* the Ninth Circuit reversed because the Tax Court failed to "detail its reasoning." The Ninth Circuit opinion reinforces that a compromise value should reflect and be grounded in the facts before the court.

The Ninth Circuit in its prior published opinions has more than once before reversed the Tax Court for similarly not grounding its decision on the evidence submitted by the parties. In *Estate of Simplot v. Commissioner*[37] the Tax Court considered possible hypothetical buyers and scenarios in arriving at a control premium. Despite the Commissioner's concession not to assume an outside buyer, the court constructed a series of possibilities that would yield a control premium. The court admonished:

> The facts supplied by the Tax Court were imaginary scenarios as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect with Simplot children or grandchildren and what improvements in management of a highly successful company an outsider purchaser might suggest. "All of these factors," i.e., all of these imagined facts, are what the Tax Court based its 3 percent premium upon. In violation of the law the Tax Court constructed particular possible purchasers.[38]

In *Trompeter v. Commissioner*,[39] the Ninth Circuit likewise reversed the Tax Court for inadequately indicating the facts relied on by the court to reach its determination of the value of certain missing coins and artifacts. It stated: "The Tax Court did not specify which portions of the trial record it referenced, detail the methodology it used to arrive at its conclusion, list the omitted assets, or even offer a description of the items."[40] A requirement that the Tax Court enunciate the basis for its conclusion based on facts in the record highlights the importance of ensuring ample factual evidence to support the conclusion the litigant hopes to achieve.

The take away from the appellate opinions in these cases is that in making a determination as to whether a Tax Court opinion should be appealed, it behooves counsel to consider whether the Tax Court has drawn its determination of value from specific evidence before it. Where the Tax Court instead draws its conclusions based on hypothetical scenarios or assumptions not supported by the evidence, it provides opportunity for an appellate court to reject the Tax Court's determination of value. The cases reveal that the Tax Court's claim of broad authority to choose a value not traceable to specific evidence is limited.

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[37] Est. of Simplot v. Comm'r, 249 F3d 1191 (9th Cir 2001).
[38] *Id.* at 1195.
[39] Trompeter v. Comm'r, 279 F3d 767 (9th Cir 2002).
[40] *Id.* at 771.

[4] Providing Sufficient Evidence

Although the appellate courts decisions have reversed the Tax Court when it has strayed from firmly grounding its assumptions on evidence in the record, for the most part the Tax Court takes care to in fact trace each valuation assumption relied upon to evidence before the court. Absent contrary evidence as to a particular assumption or method of valuation, the court is left to rely on the evidence before it. Where a party not only documents assumptions on which its own appraisal is based, but also submits testimony discrediting the specific assumptions and appraisal methods employed by the opposing party, it is more likely that the court will reach a compromise value. A compromise value typically yields a result more favorable than adoption in full of the opposing party's position.

Delving into assessment of the appraisals before the court, the Tax Court will often evaluate the strength of the appraisal on the basis of whether the appraiser provided a factual basis for assumptions key to a determination of the value. For example in *Estate of Richmond v. Commissioner,*[41] the court reviewed the appraisals and other evidence admitted to determine whether the record provided factual support for each assumption made by the appraisal. Only in finding that evidence would the court deign to rely on the assumption. In arriving at an appropriate built-in capital gains discount, the court noted that taxpayer had failed to submit evidence as to the number of years for turnover of the underlying assets and given that the Commissioner's evidence on turnover rate stood unrebutted, the court adopted the Service's assumed number of years. The principles at work in evaluating the extent to which the court may rely on the appraisal mirror the need for a factual basis. Taxpayer's counsel should review any appraisal to ensure a strong factual basis is provided for each of the key assumptions critical to the valuation.

In addition, to the extent taxpayer's and Commissioner's theories of valuation differ, each party should consider submission of expert testimony as to the appropriateness of the valuation made based on each theory. Absent such evidence by both parties, once the court adopts a specific theory, it in essence adopts the appraisal based on the theory when no contrary evidence is submitted per that theory. If in *Richmond* taxpayer had in the alternative also submitted evidence addressing assumptions made as part of Commissioner's theory that the built-in capital gain discount should be determined based on a present value analysis as opposed to a dollar-for-dollar discount, the court may have arrived at a different value. For example, if taxpayer had submitted credible evidence as to a more favorable turn-over rate, the court may have arrived at a different value.

The Tax Court in *Cavallaro v. Commissioner*[42] similarly noted taxpayer's failure to provide an appraisal based on the factual scenario asserted by Commissioner and as a result adopted the

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[41] Est. of Richmond, TC Memo 2014-26.

[42] Cavallaro v. Comm'r, 2014-189. (The court notes that the effective date provisions make IRC § 7491 to *Cavallaro*,

appraisal of the Commissioner's expert. The Tax Court, after finding taxpayer bore the burden of proof, determined that the company in which parent owned stock, as opposed to the one in which children owned stock, in fact owned the rights to use valuable technology. Commissioner's expert provided appraisals assuming parent's company owned the technology, whereas taxpayer's appraisal assumed the children's company owned the technology. The court adopted the Commissioner's appraised value explaining:

> It is the Cavallaros who have the burden of proof to show the proper amount of their tax liability, and neither of the expert valuations they provided comports with our fundamental finding that Knight owned the valuable CAM/ALOT technology before its merger with Camelot. We are thus left with the Commissioner's concession, effectively unrebutted by the party with the burden of proof. The Cavallaros risked their cases on the proposition that Camelot had owned the CAM/ALOT technology (and on a valuation that assumed that proposition), but they failed to prove that proposition (and the evidence showed it to be false). That being so, "[i]t would serve no useful purpose to review our agreement or disagreement with each and every aspect of the experts' opinions."[43]

The Tax Court's holding reinforces the importance of providing evidence regarding assumptions underlying both parties' appraisals.

The lesson gathered from a review of the court's analyses is that when the parties propound opposing theories or methods of valuation, it becomes important for each party not only to submit evidence supporting the appraisal submitted by the party, but to also submit evidence calling into question the assumptions underlying the appraisal of the opposing party. Absent such evidence, once the court finds one of the methods or theories more appropriate than the other, it is left with wholly adopting the appraisal submitted using that method or theory. By introducing evidence questioning the assumptions made by the opposing parties' appraisal, it allows the Tax Court leeway to pick and choose from the evidence before it and arrive at a compromise value.

[5] Determining Credibility of the Evidence

Not only must the taxpayer and Commissioner submit evidence into the record for the court to rely, the evidence itself must be sufficiently credible. The Tax Court critically analyzes the evidence and "reserves the right to reject or accept testimony."[44] In applying the preponderance of evidence standard, the Tax Court need not give any weight to evidence it feels lacks credibility or contains flaws. For example, in *Giovacchini v. Commissioner,* the Tax Court rejected aspects of three of the

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and the taxpayer bears the burden of proof under an application of Tax Court Rule 142.)

[43] *Id.* at 60-61.

[44] Est of Richmond, TC Memo 2014-26 at 22-23.

appraisals and relied instead on the sale price reached following the date of death as the starting point for determining value.[45] In evaluating evidence, the Tax Court may consider any number of factors. Among those factors, it has considered not only the underlying factual basis of an appraisal, but also the qualifications of the appraiser. Qualifications of the appraiser also prove important to the question of whether the court will accept the appraiser as an expert for purposes of admitting testimony. Thus, qualifications of the appraiser serve a dual purpose.

Submission of "credible evidence" by the taxpayer is a key element in shifting the burden of proof to the Commissioner.[46] By its very terms, I.R.C. Section 7491 would not lead to any shift in the burden of proof to the extent taxpayer fails to provide credible evidence of its asserted valuation. Legislative history proves instructive as to the meaning of "credible evidence" for purposes of applying I.R.C. Section 7491. It imbues the term with the following meaning:

> Credible evidence is the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted (without regard to the judicial presumption of IRS correctness). A taxpayer has not produced credible evidence for these purposes if the taxpayer merely makes implausible factual assertions, frivolous claims, or tax protestor-type arguments. The introduction of evidence will not meet this standard if the court is not convinced that it is worthy of belief. If after evidence from both sides, the court believes that the evidence is equally balanced, the court shall find that the Secretary has not sustained his burden of proof.[47]

This definition proves difficult to apply because whether "the court would find [the evidence] sufficient" is a judgment call. The Tax Court specifically asserts that it "is not obligated to pay any regard to an expert opinion that lacks credibility"[48] and may find one of the appraisals "to be more credible than that of the other party."[49]

Providing more than one appraisal with widely varying determinations of value can cause the court to conclude that all appraisals admitted into evidence lack credibility. In fact, the Tax Court in *Estate of Adell v. Commissioner,*[50] when faced with three appraisals submitted into evidence by the taxpayer, each substantially lower than the value reported on decedent's estate tax return, the court found a lack of credible evidence sufficient to shift the burden of proof. The court also rejected the Commissioner's appraisal as "unpersuasive."[51] Given the flaws in the appraisals, the court

[45] Giovacchini, TC Memo 2013-27 at 105.
[46] IRC § 7491.
[47] S. Rep. No. 105-174.
[48] Est. of Adell v. Comm'r, TC Memo 2014-155 at 44-45.
[49] *Id.*
[50] *Id.* at 39-40.
[51] *Id.* at 45.

determined value to be that which was reported on the estate tax return. In *Adell* the taxpayer bore the burden of proof and the court based its decision on a preponderance of the evidence.[52] Apparently in the absence of a "credible" appraisal the court without further proof adopted the taxpayer's reported value on the return as opposed to the value assessed by the Service which was to enjoy a presumption of correctness.

Because the law allows the Tax Court wide latitude in deciding which facts, assumptions and appraisal methods to use in support of its ultimate determination of value, counsel for the taxpayer, and for that matter the Commissioner, should review the appraisal reports to confirm substantial factual support is provided for each key assumption on which value rests. Multiple appraisals with disparate values, however, can result in a determination that none have credibility.[53] An effective strategy may be to provide expert testimony opining as to key assumptions in the underlying appraisal of the party and questioning those assumptions on which the opposing party's appraisal relies.[54]

§ 2.03 Trends in Proving Valuation Adjustments: Applying the Willing Buyer-Willing Seller Test

Fair market value presumes a willing buyer-willing seller not compelled to enter into a sale transaction and both with "reasonable knowledge" of "relevant facts."[55] "The willing buyer and seller are hypothetical, and valuation does not take into account the personal characteristics of the actual buyer or the actual seller. [Citations omitted.] The hypothetical willing buyer and seller are presumed to be dedicated to achieving the maximum economic advantage, namely the maximum profit from the hypothetical sale."[56] Courts acknowledge that the determination of value "begins and ends with the proper administration of the ubiquitous willing buyer/willing seller test…."[57]

Recent cases highlight the importance and impact of the court's determination of relevant facts. Relevant facts include, among others, those characteristics unique to the property being valued. It is generally those facts known at time of death that are relevant.[58] To the extent the appraisals before the court hinge on specific facts, it behooves the parties to submit evidence documenting the relevant facts. In evaluating the opposing party's characterization and development of the relevant facts, it is also important to submit evidence calling into question that characterization of the relevant facts as appropriate.

Unique characteristics of an asset impact value. The characteristic may increase or decrease an asset's value and consequently the appraised value should reflect an adjustment for the impact of

[52] *Id.* at 40.
[53] *See* Est. of Adell, TC Memo 2014-155.
[54] *See* Giovacchini, TC Memo 2013-27.
[55] Treas Reg § 20.2031-1(b); Treas Reg § 25.2512-1.
[56] Est. of Adell, TC Memo. 2014-155 at 41-42 (citing Estate of Curry v. US, 706 F2d 1424, 1428-1429, 1431 (7th Cir 1983); Estate of Noble v. Comm'r, TC Memo 2005-2.
[57] Est. of Elkins, 767 F3d 443, 446 (5th Cir 2014).
[58] See Est. of Kessel v. Comm'r, TC Memo 2014-97.

any distinctive features of an asset. Examples of these unique characteristics when valuing closely-held businesses with no ready market include discounts for minority interest, adjustments for the impact of built-in capital gain, and key man discounts to reflect the value of decedent's contribution, to name a few. When valuing land, adjustments to value may include, for example, the impact on value of environmental liabilities associated with the property, the lack of easy access, and the size of the parcel. Key to arriving at an appropriate value is to take into account and document characteristics that justify a departure from an assumption underlying the method of valuation used.

Recent cases highlight trends and reinforce application of basic principles underlying the willing buyer-willing seller test for determining fair market value. The discussion below focuses on trends in determination and application of valuation adjustments. It centers on three adjustments that have been the focus of litigation in recent years. Specifically, important trends include adjustments for the value associated with key-employees, adjustments based on the present value of the tax cost associated with built-in capital gains, and fractional and lack of marketability discounts related to tenant-in-common interests in art.

[1] Allowing an Adjustment for Employee Personal Goodwill

For many years courts have adjusted value of closely-held business interests for the loss of decedent's expertise when the success of the business depended on decedent's efforts, often referred to as a key man discount.[59] In a closely-held business, management can greatly impact, for better or worse, the return received by investors. Recent cases recognize the appropriateness of adjusting value for key employees, including family members, where there is no effective non-compete agreement.

At issue in *Estate of Adell v. Commissioner*[60] was the value of decedent's 100 percent stock interest in a for profit company, STN.com, which at his death was operated and managed by his son as president. Decedent's company, a cable uplinking company, had as its sole client a nonprofit religious programming broadcaster known as The Word. Decedent's son maintained the primary client relationship with The Word, but did not have in place an employment contract nor a noncompete agreement with decedent's company. Both the estate's appraisal and the Service's appraisal recognized the appropriateness of an adjustment to value for the personal good will of decedent's son which did not belong to the company.

The adjustment for personal goodwill derived from the fact that the company did not own that goodwill. In reviewing the taxpayer's appraisal, the court noted the following as indicated by the evidence:

[5959] *See, e.g.,*Desmond v. Comm'r, TC Memo 1999-76; Furman v. Comm'r, TC Memo 1998-157, Est. of Rodriguez v. Comm'r, TC Memo 1989-13.
[60] Est. of Adell, TC Memo 2014-155

> [The estate's appraiser] explained that the adjustment was appropriate because the success of [decedent's company] depended heavily on [the son's] personal relationships with the board of directors of The Word. Moreover, [the son] did not have a noncompete agreement with [decedent's], and as a result a potential buyer would acquire [decedent's company] only to the extent that the company retained [the son].[61]

The court in arriving at value allowed an adjustment to value for the personal goodwill of the son explaining:

> Goodwill is often defined as the expectation of continued patronage by existing customers. [Citation omitted.] A key employee may personally create and own goodwill independent of the corporate employer by developing client relationships. [Citation omitted.] The corporation may benefit from using the personally developed goodwill while the key employee works for the entity, but the corporation does not own the goodwill and therefore it is not considered a corporate asset…. The employee may, however, transfer any personal goodwill to the employer through a covenant not to compete or other agreement that transfers the relationships to the employer. [Citations omitted.] Absent such an agreement, the employer cannot freely use the asset and the value of the goodwill should not be attributed to the corporation.[62]

In fact shortly after decedent's death, decedent's son started his own corporation, encouraged The Word to move its programming to the new corporation, and left decedent's trust of which he and his two sisters were beneficiaries with stock in a corporation whose principal client had moved to the son's corporation, leaving decedent's corporation without customers. Although the son may have breached duties owed the corporation and the trust on several fronts, the court's holding recognizes that in general the duty of employees not to compete absent an enforceable agreement is narrowly construed.

In a different case, *Bross Trucking v. Commissioner*[63] the Service asserted parent made a gift of the goodwill of his trucking company to his sons who began a new trucking company with some of the assets and employees from parent's company. The court found that the parent's company did not own any goodwill that could be transferred. It specifically found that parent had not entered into an employment agreement or a noncompete agreement with the company, and for that reason the company did not own the personal goodwill of parent and rejected the Service's argument that a transfer for less than adequate consideration had occurred. It further reflected that the sons had sufficiently close relations with former customers of parent's company to develop the necessary

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[61] *Id.* at 26-27.
[62] *Id.* at 39 (citing Network Morning Ledger Co. v. U.S., 507 US 546, 572-573 (1993), Martin Ice Cream Co. v. Comm'r, 110 TC 189, 207-208 (1998), and H&M, Inc. v. Comm'r, TC Memo 2012-290.
[63] Bross Trucking v. Comm'r, TC Memo 2014-107.

business relationships with the sons' new company. Like in *Adell*, critical to the court's holding was proof that the employee had not entered into any agreement with the company that could be characterized to transfer personal goodwill.

These recent cases acknowledge that personal goodwill of a key employee may be taken into account in the determination of the value of any transfer for gift or estate tax purposes. Important to each of the holdings was proof submitted that the employee whose personal goodwill was at issue did not enter into a noncompete with the company and that the employee could continue to use for the employee's personal benefit the relationships developed while at the company. Personal goodwill is a relevant fact in valuation of many closely held companies reliant on customer relationships.

[2] Applying Fractional Interest Discounts to Art

The value of a fractional interest in property generally is worth less than the proportionate ownership interest. The Service, however, has taken the position that because there is no market for a fractional interest in artwork, forcing fractional owners to sell the work of art in its entirety, no adjustment to value should be made for the fractional interest. The Tax Court once again in *Estate of Elkins v. Commissioner*,[64] confirms that value should indeed be adjusted for fractional interests in artwork. It has done so before.[65] In prior cases, only a nominal 5 percent fractional interest discount was allowed by the courts. The Tax Court in *Elkins* noted the nominal discounts in prior cases were due to a lack of proof that a larger discount should be applied. Taking note of the need to submit evidence supporting a greater discount, taxpayer in *Elkins* entered into the record testimony supporting discounts of between 51 and 79 percent for the various works of art, with the Tax Court determining a 10 percent discount. In light of a lack of any proof as to an appropriate discount by the Commissioner, the Fifth Circuit reversed the Tax Court's discount in favor of those discounts supported in the taxpayer's appraisal. Careful documentation as to each relevant fact in support of a valuation adjustment saved the estate in *Elkins* in excess of $14 million.[66]

While, the *Elkins* appellate decision is most notable for its recognition of fractional interest discounts in artwork and for its insistence that in arriving at an ultimate value, the Tax Court's findings must be based on some evidentiary support, the opinions of both the Tax Court and the Fifth Circuit provide instructive insights into facts relevant to a determination of value for fractional interests in artwork. The court took into account "the heirs' financial strengths, their out-of-hand rejection of the idea of ever selling their interests, and the time and money that the legal restraints in their arsenal would cost a willing buyer…"[67] It further found the Tax Court gave "short shrift to the time and expense that a successful willing buyer would face in litigating the restraints on alienation and possession and otherwise outwaiting those particular co-owners." [68] Thus, the position of the

[64] Est. of Elkins, 140 TC 86 (2013), *aff'd in part and rev'd in part*, 767 F3d 443 (5th Cir 2014).
[65] *See* Est. of Scull v. Comm'r, T.C. Memo. 1994-211. *See also* Stone v. U.S., 2007 US Dist LEXIS 38332 (ND Cal 2007), *aff'd* 2009 US App LEXIS 6347 (9th Cir. 2009) (allowing a fractional interest discount for art).
[66] Est. of Elkins, 767 F3d 443 (5th Cir 2014)(referencing taxpayer's appraisal set forth in an exhibit to the Tax Court opinion, 140 TC 86 (2013)).
[67] Est. of Elkins, 767 F3d at 452.
[68] *Id*. at 451.

other co-owners proved relevant. The estate offered testimony of one of the heirs and fractional interest owners, and also testimony of three experts – an expert in art valuation, an attorney expert in the costs of partition and enforcement of legal restraints, and an expert in valuation of fractional interests. The appellate court found this testimony to adequately support the claimed substantial discounts by taxpayer.

The *Elkins* decision confirms the ability to claim a fractional interest discount in works of art. It also highlights that relevant facts in the determination of value include factors that a hypothetical buyer would take into account including legal restraints to which the property is subject and the expressed intent as to sale of the artwork by the other heirs. Because in the future the Commissioner will likely not make the same mistake of failing to submit evidence as to an appropriate valuation adjustment, the ultimate valuation discount allowed be tempered in light of the evidence submitted by both parties and likely not reach the high discounts allowed in *Elkins*.

[3] Determining an Allowable Built-In Capital Gains Discount

The built-in capital gain characteristic of C corporations is relevant to determining value of closely-held stock. The Second Circuit initially recognized the appropriateness of a valuation adjustment in *Eisenberg v. Commissioner*.[69] A split of authority among the circuits has developed as to the appropriate method for determining the built-in capital gain discount. The Fifth and the Eleventh circuits apply a dollar-for-dollar adjustment. The Second and the Sixth Circuits use a present value approach based on assumptions as to how quickly a corporation might turn over its assets and be forced to recognize the built in gain. The Tax Court has steadfastly maintained that the latter present value approach is correct, and does so again in its recent decision in *Estate of Richmond v. Commissioner*.[70]

The present value approach applied by the Tax Court recognizes that the built-in capital gains will likely not be recognized immediately, but only as the corporation turns over its assets over the course of time will it be required to pay the tax associated with those gains. The Tax Court's analysis contrasts built-in gains with payment of a demand note that would in fact require payment and would leave the corporation with fewer assets to invest immediately upon its payment. It explains the taxpayer: "may defer the payment of the [built in gains tax] as long as he retains the appreciated stock; in the future -- until he sells off the appreciated stock over time and incurs the tax piecemeal over that period -- he will receive the capital gains and dividends generated by the entire … portfolio."[71] Key to a determination of the discount for the built-in capital gains tax under the court's present value method is the assumption as to the number of years required for the turn over. At the Tax Court level, even if the taxpayer takes the position that the discount should be calculated on a dollar-for-dollar basis, taxpayer should consider submitting evidence establishing the shortest turn-over rate that can be supported by the relevant facts so that the court, if it chooses, can base the discount on a turn-over rate more favorable than that submitted by the Commissioner. The taxpayer

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[69] Eisenberg v. Comm'r, 155 F3d 50 (2d Cir 1998).
[70] Est. of Richmond, TC Memo 2014-26.
[71] *Id*.

should anticipate that, unless the case is appealable to the Fifth or Eleventh Circuits, at least at the trial level a present value analysis will prevail.

§ 2.04 Conclusion

Recent appellate court decisions narrow the latitude of the Tax Court to arrive at value. The Tax Court often begins its analysis by laying claim to broad discretion in its review of the evidence and ability to arrive at a compromise value including the ability to arrive at value without directly tracing it decision to specific testimony. The circuit courts in response constrain the discretion of the Tax Court by requiring it to detail its reasoning and indicate the factual evidence on which each assumption underlying the determination of value rests. The recent opinions reaffirm the need for the Tax Court to point to specific evidence in the record supporting the analysis relied on to arrive at value and, correspondingly, for the parties to ensure that such evidence has been admitted either as part of the appraisal, by stipulation or through testimony at trial. In the final analysis submission of evidence as to all relevant facts impacting value is important to reaching a result in favor of the client. Adjustments to value are appropriate to extent a fact specific to the asset impacts the amount a willing buyer would pay for the asset.

It is also evident that regardless of whether the taxpayer or the Commissioner bears the burden of proof, the court analyzes the evidence based on a preponderance of evidence standard. Application of the preponderance of evidence standard typically leads to a compromise value within the range of values provided by the parties' appraisals, as opposed to adoption of either party's appraisal in full. Thus, it is not enough simply to submit an appraisal of value. In light of the ability of the court to pick and choose from the various assumptions embedded in the parties' appraisals, it is important that the appraisal itself provide a factual basis at each juncture in arriving at overall value. Careful consideration should be given to what facts characteristic of the property to be valued set it apart as such characteristics may lead to a favorable adjustment in value.