Tax Law: Engaging Appraisers for Closely-Held Business Interests

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Ronald Feuerstein
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Frequently, we will tell clients that their business must be appraised or valued. Sometimes, clients will ask us about the need to do so.

The need for valuations arises in numerous contexts under tax law. While the most obvious need for valuations occurs in business sales and acquisitions, tax law requires valuations for non-publicly traded stock given outright as compensation, in the form of options (qualified or non-qualified) or in the form of "restricted stock" under Internal Revenue Code ("IRC") section 83 compensation.

IRC section 409A, which governs non-qualified deferred compensation, requires valuations for non-qualified stock options with more onerous rules than were in place prior to its enactment in 2004.

Another area where tax law requires appraisals is employee stock ownership plans ("ESOPs"). Specialized appraisers need to value ESOP stock at formation and each year thereafter, in addition to when a participant's stock is purchased.

Yet another area where valuation is a necessity is charitable gift giving.

The above transactions are, by no means, exhaustive but provide some examples of the broad application of valuation requirements under tax law.

In determining the value of closely-held business interests, the entity's net worth, earning power and, in the case of C corporations, dividend-paying capacity, are taken into account. Moreover, after these factors are taken into account, the interests maybe discounted (i.e., its value for tax purposes is reduced) for a number of reasons, such as lack of marketability or lack of control ("minority discount"), which is a hotly contested and litigious area of tax law.

In the context of buying or selling a business, hiring a qualified appraiser can help you assess the validity of your own determination of investment value (i.e., the return on your investment in the closely-held business), and help you structure an offer and convince the seller of a negotiating price range.

Clients may also need an independent appraisal to obtain financing or to provide documentation to support any valuation. Where the valuation of a closely-held business is relevant to the correctness of a tax return, the taxpayer must submit with the return complete financial data on which the valuation is based, including copies of reports of any examination made by accountants, engineers or technical experts, as of or near, the valuation date.

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Thus, the appraiser's report can provide both financial and tax substantiation. Should the valuation issue become the subject of litigation with the IRS, the appraiser's expert testimony can be the best way of presenting the factors used to value closely-held business interests. In fact, it would appear that the taxpayer can even shift the burden of proof to the IRS on the valuation issue if the appraiser's testimony provides credible evidence.

Caution is appropriate in reviewing an expert's qualifications. In the event of tax litigation, the general standard applied to the admissibility of an expert's opinion is whether that testimony would assist the trier of fact in deciding the case. If an appraiser's techniques, experience or qualifications are found unreliable and irrelevant, a Federal court or United States Tax Court judge may find that the expert's testimony does not meet the admissibility standards of Federal Rule of Evidence 702 and, thus, the testimony will not be evidence in the case.

To save time and money, it may make sense to find an appraiser who can provide both asset appraisals and business valuation. In any case, you should check the appraiser's references, experience and credentials. In that regard, you need to determine whether the appraiser has been certified or accredited by the American Society of Appraisers (ASA), the Institute of Business Appraisers (IBA), the National Association of Certified Valuation Analysts (NACVA) or the American Institute of Certified Public Accountants (AICPA).

The client should also ask whether the appraiser is familiar with the widely recognized professional standards for appraisers. The Uniform Standards of Professional Appraisal Practice (USPAP) and the Principles of Appraisal Practice and Code of Ethics (PAPCE) establish authoritative principles and a code of professional ethics for appraisers. In addition, the Business Valuation Standards (BVS) of the American Society of Appraisers supplements and clarifies the USPAP and the PAPCE with respect to the valuation of businesses, business ownership interests and securities.

One should also select an appraiser who has actual practical experience in buying or selling businesses or valuing specialized assets (such as intellectual property), as the case may be. Moreover, it would be a good idea to inquire whether the appraiser has experience testifying as an expert witness to establish valuation and whether the appraiser has represented both taxpayers and IRS. The fact that an appraiser has provided expert testimony on behalf of taxpayers and IRS can add to the appraiser's credibility should you someday need his or her testimony to establish valuation.

For each of the foregoing reasons, it is essential that you select an appraiser whose qualifications, experience and analysis are beyond reproach whenever possible.