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THE PRACTICAL **TAX LAWYER**

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TWENTY THINGS REAL ESTATE ATTORNEYS CAN DO TO NOT MESS UP A SECTION 1031 EXCHANGE (PART 2: ITEMS 11–20)

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Brad is the author of several books and numerous articles in leading tax and legal journals. His books include Federal Income Taxation, (Foundation Press, 7th ed. 2017, with Martin J. McMahon, Jr., Daniel L. Simmons & Dennis J. Ventry, Jr.); Federal Taxation of Corporations and Corporate Transactions (Aspen Publishers 2018, with Steven A. Dean); Limited Liability Entities: A State-by-State Guide to LLCS, LPs and LLPs (Wolters Kluwer Law & Business 2012, seven annual updates, with Robert J. Rhee); LLCS and Partnerships: Law, Finance, and Tax Planning (Wolters Kluwer 2019); Taxation and Business Planning for Partnerships and LLCs (Aspen Publishers 2017); Taxation and Business Planning for Real Estate Transactions (Carolina Academic Press, 2nd ed. 2017); and Tax-Free Like-Kind Exchanges (Civic Research Institute, 2nd ed. 2015). His articles are published in professional journals, such as Business Entities, The Journal of Taxation, Probate and Property, Real Estate Finance Journal, Real Estate Taxation, Tax Management Real Estate Journal, and Tax Notes, and law reviews, such as Brooklyn Law Review, Florida Law Review, Florida Tax Review, Georgia Law Review, Houston Law Review, Iowa Law Review, Kansas Law Review, University of Pennsylvania Journal of Business Law, The Tax Lawyer, and Virginia Tax Review. He is also columnist for Journal of Passthrough Entities. He has given more than 250 presentations on topics related to his scholarship.

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Part 1 of this article focused on the issues that arise as property owners begin contemplating an exchange, matters to consider when selecting a QI, and events to plan for as an exchange gets started and the end of the 45-day identification period approaches.[1] This Part II of the article considers complex transactions and matters that real estate attorneys should keep in mind as they work with their clients to ensure exchanges progress smoothly and wrap up according to the exchangers' desired tax goals.

Since the manuscript for Part I was submitted, much has happened in the section 1031 space. Adjustments related to COVID-19 have stalled many section 1031 exchanges. The IRS provided guidance that extends 45-day identification periods and 180-day exchange periods that would otherwise expire between April 1 and July 15. That guidance brought relief to some exchangers, but the industry generally hoped that the IRS would have done more.[2] As of the writing of this article, the IRS has yet to issue additional guidance, but it indicated that it would.[3] That guidance, if sufficiently generous, will help exchangers better navigate the economic fallout of the pandemic. Many exchanges that stalled will eventually move forward (sooner with the help of generous IRS guidance), and, as the exchange industry returns to capacity, the items discussed in this article will be important to remember. Having

covered items 1 through 10 in Part I, this Part II of the article picks up with item 11.

11. Don't drop the ball on a drop-and-swap

Drop-and-swaps have become commonplace, and many real estate attorneys see several of these types of transactions each year. A drop-and-swap is a series of transactions that often starts when a tax partnership (i.e., a partnership or LLC taxed as a partnership) receives an offer to purchase its property and the members disagree about how to reinvest the proceeds. Some members of the tax partnership might prefer to reinvest the proceeds in like-kind property as part of a section 1031 exchange; others might wish to do their own exchange, and others might wish to take cash and forgo other investments in real estate. To accommodate all parties, the tax partnership can consider liquidating by distributing tenancy-in-common (TIC) interests to each of the members. The members could then do as they please with their respective TIC interests.

Even though drop-and-swaps are easy to explain, they are complex transactions and have a few potential tax traps. When advising a client with respect to a drop-and-swap, remember that the property must be held as a TIC for tax purposes following the distribution. The advisor must understand the difference between a TIC and a partnership under tax law. For the members of a tax partnership to be treated as TIC co-owners, the partnership must distribute tax ownership of the TIC interests to the members, i.e., the members must acquire the benefits and burdens of the TIC interests.

If the partnership negotiates, the sale enters into the purchase agreement, and takes all of the actions necessary to sell the property, the IRS and courts could treat the partnership as holding the benefits and burdens and as owning the property at the time of the sale. If the partnership owns and sells the property, then it must complete the section 1031 exchange by acquiring the replacement property. Ensuring that tax ownership passes from a tax partnership to the member or members and that the post-distribution arrangement is a TIC, requires prior proper planning. Thus, it is best to get the wheels of a drop-and-swap turning well before the sale occurs.

12. Know what a TIC is and isn't

Having heard about drop-and-swaps, some real estate lawyers may believe that they can accomplish a good drop-and-swap by simply deeding the property from the partnership to the members as TICs right before closing. Unfortunately, tax law might not treat the ownership arrangement of a last-minute distribution followed immediately by a sale as a TIC. Experts in partnership classification believe that for an arrangement to be a valid TIC, it must have a few fundamental TIC characteristics. First, the members must generally have rights to partition the property and sell their TIC interests. Second, any blanket liens on the property should be borne by the members in proportion to their ownership interests. Third, revenue and expenses should be shared by the owners in proportion to their ownership interests. Fourth, the members should share in the management and decision-making related to the property. To comply with these requirements, co-owners of TIC arrangements typically adopt a TIC agreement and a management agreement.

Distributing TIC interests immediately prior to the sale of property raises questions about the status of the interest owned and transferred. If the property is held by the members for only an instant, the members may have difficulty establishing that the transitory arrangement was a TIC. For instance, they might not be able to show that they shared revenue and expenses according to their ownership interests, that they had rights to partition, that they had management rights, that they shared the blanket liens in proportion to their ownership interests, and that they satisfy the other criteria of a TIC for the brief instant between the distribution and the transfer. A properly structured drop-and-swap ensures that the property is distributed and held as a TIC before it is transferred to the buyer.

On the buyer side, exchangers often look to purchase TIC interests as replacement property. They

may intend to hold those interests passively, or they may wish to participate in the management of the acquired property. For instance, a developer may wish to be part of a venture to acquire and develop land. The developer may prefer to acquire its interest in the property as part of section 1031 exchange. The developer cannot acquire a joint venture interest (i.e., an interest in a partnership or LLC) as part of an exchange, but it could acquire a TIC interest in the property to be developed. After establishing tax ownership of a TIC interest, the developer might consider contributing the property to a joint venture. From a tax planning standpoint, the developer is probably better off exchanging into a single TIC that will be folded into a joint venture (i.e., a quick TIC) than exchanging into a complex TIC that will develop property. A TIC that develops property often will be so complex that it could start to look like a tax partnership. Based upon Magneson v. Commissioner and its progeny,[4] the quick TIC can have TIC tax attributes and then fold into the joint venture without negating the section 1031 exchange. With quick TICs, be certain the exchanger is the tax owner of the TIC interest and ensure that the stop transaction doctrine does not disregard that step.

Closely held TICs have become very prevalent. Sponsors of real estate funds and joint ventures want to use equity and management structures for such TICs that they use in their joint ventures, complete with profit-sharing and promotes. Some TIC arrangements have TIC agreements and management agreements that appear to comply with Rev. Proc. 2002-22 also include side letters that may introduce profit-sharing or management features that deviate from the guidelines in Rev. Proc. 2002-22. If the arrangements in the side letters would disrupt the TIC classification if they were in the TIC agreement or management agreement, they will likely disrupt the classification from outside those agreements. Because distinguishing between a tax partnership and a TIC is so difficult in many situations, one would not expect to see tax authorities aggressively challenge arrangements that do not perfectly comply with the Rev. Proc. 2002-22 conditions. Nonetheless, egregious deviations may attract the attention of taxing authorities, so don't deviate too far from the guidelines. Profit sharing that is not in proportion to ownership interests may be a deviation that strays too far from the guidelines, and it is easy for tax authorities to recognize and challenge. Some observers believe that arrangements within the entity structures of TIC owners might be a better way to deal with profit sharing and promotes. For instance, a manager may become a member of an LLC investor that is buying a TIC interest and get a profits interest for managing that entity or providing management services to it, instead of receiving a profits interest through the TIC management agreement. If the law respects every entity in the structure, then arrangements in the upper-tier entities or TIC should not disrupt the TIC classification. Issues related to side letters and agreements with structures are still being explored and fleshed out. Industry practices should normalize relatively quickly as demand for such structures grows. In the meantime, be careful to ensure that your arrangement does not become an example of how not to structure a TIC.

13. Know that an S corporation is not a tax partnership

Partnerships and S corporations are both pass-through entities, so they do not pay an entity-level tax. Instead, the income of both types of entities flows through to the members who pay tax on their respective shares of it. Despite that similarity, partnerships and S corporations are different in significant ways that are relevant in the section 1031 context. For instance, S corporations typically recognize gain when they distribute appreciated property to their members, and they must allocate recognized gain pro rata to the shareholders based upon the shareholders' ownership interests in the S corporation. Therefore, S corporations cannot do drop-and-swaps in the same way that partnerships can. If an S corporation simply distributes appreciated property to the shareholders, the corporation recognizes gain, allocates the gain to the members in proportion to their interests in the S corporation, and the members take a fair market value basis in the distributed property. After that gain recognition, the members would have no reason to do exchanges. If only one member wanted to cash out,

the S corporation would recognize gain if it were to distribute an undivided interest to the cash-out member or receive cash boot on the sale of property as part of a section 1031 exchange, and it would have to allocate that gain pro rata to the members.

Shareholders do not, however, have to abandon all hope of dividing S corporations tax-free in proximity to doing an exchange. S corporations are subject to the general corporate tax rules, which allow for tax-free divisions. To obtain tax-free treatment on a division of a corporation, the division must have a non-tax business purpose, the pre-division corporation must have an active trade or business, the shareholders must retain their proprietary interests in at least one of the corporations that results from the division, and the business of the divided corporation must continue after the division.[5] These rules limit the types of S corporations that are eligible for tax-free divisions and may restrict the timing of such divisions. An S corporation may have difficulty satisfying the business purpose requirement if it distributes TIC interests to the members as part of the division. Often, the most obvious business purpose for doing a division is a management dispute and disagreement regarding the use and disposition of the corporation's property. If an S corporation has multiple members and multiple properties and divides the management of the properties among the members, a purpose for dividing may be to grant specific members greater management latitude with respect to specific properties. A fundamental attribute of a TIC is that the TIC owners participate in the management of the TIC property, so a division resulting in multiple corporations owning TIC interests probably would have to have a business purpose other than management differences.

An S corporation with multiple properties probably could do a tax-free division by distributing a property out to one of the shareholders. Following such a division, the new corporation and the dividing corporation would both hold at least one property. Each corporation should then be able to do a section 1031 exchange without disrupting the tax-free division. The division could, however, lose its tax-free status if either resulting corporation started but failed to complete an exchange. An S corporation should also be able to exchange out of one property into multiple other properties and then do a tax-free division. After a corporate division, the resulting entities will be corporations. Continued corporate ownership is not the ideal structure of real property (the owners would probably prefer to own the properties in tax partnerships), but a tax-free division does allow the owners to go their separate ways. Tax-free divisions of corporations have several technical requirements, so do them with care to ensure all the technical requirements are satisfied.

14. Recognize you're not a DST, NNN, or TIC broker

A significant marketplace exists for packaged replacement property, such as DSTs (interests in Delaware statutory trusts), NNNs (triple-net properties), and syndicated TICs. Each of these products provides passive investments for parties looking for real estate interests and minimal management responsibilities. For instance, triple-net properties are typically stand-alone properties with credit tenants. Exchangers often transfer out of property they have owned and managed and with which they are familiar into triple-net properties with which they have little or no familiarity. Some exchangers will visit such properties before acquiring them; others buy them sight unseen relying solely on financial information provided by the seller and the tenant's credit worthiness.

DSTs have become a popular form of replacement property. They allow investors to buy a fractional interest in a larger property or properties. A DST is a legal entity that tax law disregards if the DST satisfies certain requirements that create a fixed investment for members of the DST. The fixed investment requirement prohibits the DST from refinancing, making significant structural improvements to, or negotiating new leases for its property. Those restrictions should generally limit DSTs to owning new construction or recently renovated property. When property owned by a DST reaches a point that requires renovation, the DST must sell it.

Syndicated TICs were popular in the 2000s prior to the financial crisis, but they have lost their luster. An investor could probably find a syndicated TIC to invest in, but sponsors and lenders prefer DSTs because they employ a separate legal entity.

Investors should note how COVID-19 affects these types of arrangements. Rent payments and other revenue from the properties might decrease significantly for some types of properties, such as student housing, office buildings, and hotels. Reportedly, sales of DSTs that were on the market before COVID-19 have slowed. Loss of rent revenue will affect DST distributions. The situation at the time of this writing is worrisome for parties in the DST space. The speed at which the economy returns to normal will affect recovery of this market segment.

Real estate lawyers should be familiar with the legal aspects of TICs, DSTs, and triple-net replacement properties, but they should be careful not to promote any particular property. The industry is effective at getting their product in front of potential investors. Attorneys should be sure that any advice they give with respect to potential replacement property is within the scope of their representation, and they should recognize that not all products or sponsors adhere to the same standards of care and quality. Attorneys should also remember that their ethical duties require them to represent the client and should be certain any product their client is considering complies with section 1031 or other tax rules relevant to the transaction.

15. Use caution if replacement property comes from a related party

The IRS and courts do not like exchangers acquiring replacement property from related parties and generally deny section 1031 nonrecognition to such transactions. Courts have decided several cases with such facts, and the exchangers have lost in every case. The related-party exchange rules provide a defense for exchanges that are not tax motivated. Perhaps an exchanger could argue for the application of this no-tax-avoidance defense if the related party recognizes gain and pays more tax on more gain than the exchanger defers. An exchanger typically would not acquire property from a related party if the acquisition would not yield greater tax savings, so this no-tax-avoidance defense typically will not be available. If the related party recognizes gain but has losses to offset the gain, courts do not appear willing to grant the exchanger nonrecognition of gain on the exchange, even if the related party's recognized gain exceeds the exchanger's deferred gain.

16. Know that serial exchanges are an exception to the general related-party prohibition

One exception to the rule prohibiting the acquisition of replacement property from a related party is a transaction in which the related party uses the proceeds to do its own exchange. With such transactions, the IRS has privately ruled that the exchanger's and related party's exchanges can qualify for section 1031 treatment. The related party can also acquire its replacement property from a second related party if the second related party does a section 1031 exchange. An ownership structure with several properties owned in several different related tax entities such as a large REIT or real estate fund, could string several exchanges together with a series of connected exchanges. The ability to string exchanges together in this manner gives these structures the appellation "serial exchanges" or "daisy-chain exchanges."

The benefit of serial exchanges should be obvious. If the related-party group is considered a single economic unit, then serial exchanges allow the economic unit to extend the 45-day identification period and 180-day exchange period indefinitely. If an exchanger anticipates it will not be ready to complete the exchange within its 180-day exchange period, it can identify a related party's property and acquire it prior to the end of the 180-day period. The related party then has 45 days to identify replacement property and 180 days to acquire it. If the related party is concerned that it won't be able to acquire replacement property within its 180-day exchange period, it can identify another related party's property and keep the chain going by acquiring

replacement property from that other related party. The possibility of benefitting from serial exchanges may prompt some property owners to structure ownership of multiple properties with multiple related entities. Creating related parties to own separate properties can also lay the groundwork for doing leasehold improvement exchanges.[6]

17. Selling to a related party is probably fine

The IRS allows exchangers to sell relinquished property to a related party and do an exchange (through a QI) with the proceeds the related party pays for the property. Knowing this can come in handy if the exchanger is considering doing a so-called Bramblett exchange in which it locks in capital gain treatment on property held for investment before selling it to a related-party developer.[7] The investment entity in such a transaction should be able to use the proceeds from the sale to the related-party developer to do a section 1031 exchange (if the developer entity acquires the property with a note, then the transaction will require additional planning). There may be other reasons for selling property to a related party as part of a section 1031 exchange, so be aware that the IRS has sanctioned such transactions.

18. Know when the exchange period ends

The exchange period runs until 180 days after the exchanger transfers the relinquished property. That period can be cut short if the tax return due date for the year of the exchange is before the end of the 180-day period. Know that your client can avoid having the 180-day period cut short by filing an extension. Thus, if an exchange starts towards the end of the taxable year (assuming a calendar taxable year) and the 180-day period will end after March 15, if the exchanger is a partnership or S corporation, or after April 15, if the exchanger is an individual or C corporation, let your client know to file an extension to get the full benefit of the 180-day period, assuming the exchanger needs additional time to complete the exchange. Due to COVID-19, the 2020 filing deadlines between April 1 and July 15 have been extended until July 15.[8] Such extensions are not typical, but when they happen they could be relevant to the exchange period. If the exchanger prefers to receive exchange proceeds and not continue the exchange, advise the exchanger to not extend the return and to not take advantage of any extension relief. When the exchange period ends, the (g)(6) restrictions cease to apply.

The 180-day period can only be extended by the IRS for a limited number of reasons, which require other federal action, such as a federally declared disaster.[9] Absent such an extension, the 180-day period is definitive, and it can end on a holiday or weekend, so be sure to close on property before the end of the exchange period, if necessary.

19. Follow the money: replace value, replace equity

Cash is king in section 1031 exchanges, just like it is with most other things, because an exchanger's actual or constructive receipt of cash will trigger gain recognition. Real estate attorneys should pay close attention to the flow of funds, ensuring that proceeds from the sale of relinquished property get to the QI and get used to acquire replacement property. To totally defer gain, an exchanger must acquire replacement property that is equal to or greater in value than the relinquished property (the equal-value rule), and the equity (value of the property minus the debt encumbering it) in the replacement property must be equal to or greater than the equity in the relinquished property (the equal-equity rule). Thus, if the relinquished property has debt, the exchanger can defer all of the gain on the sale of that property only by replacing the debt or putting additional capital into the acquisition replacement property.

Often, acquisition financing will include funds for capital improvements to the replacement property. In such situations, the sum of the loan proceeds and exchange proceeds coming to closing might exceed the value of the replacement property (perhaps the extra proceeds will be used for capital improvements), but the exchanger must comply with the equal-value rule and the equal-equity rule to avoid gain recognition. Assuming the

replacement property satisfies the equal-value rule, the exchanger can satisfy the equal-equity rule only by ensuring that all of the exchange proceeds are used to acquire the replacement property and any extra cash comes from financing. The most conservative way to ensure that the extra cash comes from a loan is to close on the replacement property and then enter into a new loan for the extra proceeds. Often that course of action is not feasible because the lender will only do one set of loan documents and is not interested in delaying the distribution of proceeds. A next-best course of action is to ensure that the closing statement clearly identifies the exchange proceeds being used to acquire the replacement property and that any cash the exchanger receives comes from the loan.

At a courtesy meeting with the IRS as part of the American Bar Association Tax Section meeting in May 2019, attorneys at the IRS Chief Counsel's Office indicated that tracing exchange proceeds from the QI to seller and loan proceeds from the lender to exchanger is acceptable. They suggested that as long as the exchange satisfies both the equal-value rule and the equal-equity rule (the loan proceeds received by the exchanger at closing would not be considered debt for purposes of computing the property's equity), the cash received at closing should not be treated as boot. Although such communication is not an authoritative statement of law, it did give confidence to the practitioners present at the meeting to move forward with such transactions when no other alternatives are feasible.

Real estate attorneys should also be mindful that closing adjustments can have tax consequences. Transaction costs, such as attorneys' fees, transfer taxes, QI fees, brokers fees, and survey and engineering fees, paid at closing reduce the amount realized of sold property or increase the basis (i.e., cost) of acquired property (in the case of purchased property, but use of exchange proceeds to pay those costs should not affect the basis of property acquired in an exchange), so they do not affect the taxability of an exchange. Adjustments for prepaid rent, taxes, security deposits, and other items can have tax consequences. Any exchange proceeds used to pay such items for the seller will be boot to the seller. If the items are deductible, the deduction will offset the boot, but if the parties can ensure that the exchange proceeds go to the QI and the adjustments get paid outside the closing, the seller could take the deduction against other income.

In the case of security deposits transferred to the buyer, if the deposits are paid out of exchange proceeds through a credit to the purchase price, the buyer would most likely have boot and have no offsetting current deduction. In such a situation, the buyer should insist upon having the seller write a separate check to transfer the security deposits. Real estate attorneys should take the closing statement seriously and identify any items that could trigger boot. Some exchangers may prefer to settle those items on a separate closing statement and use proceeds from sources other than the exchange proceeds to pay for those items.

20. Have the best section 1031 people in your contacts folder

Section 1031 has become commonplace and many real estate attorneys have done dozens, hundreds, or even thousands of section 1031 exchanges. Such attorneys are very familiar with the section 1031 exchange process, but many exchanges involve complex tax matters or tax issues outside of section 1031. Get a section 1031 expert on board whose expertise covers section 1031 and other relevant areas of tax law to ensure that all technical requirements are satisfied and other tax issues are considered.

Section 1031 can be a wonderful tax-saving device. Some exchanges seem routine, and you may feel comfortable relying solely on the QI for tax advice regarding your exchange. Use caution in doing so. Qualified intermediaries generally include disclaimers in their documents and marketing materials providing notice that they do not provide tax advice. If they are not your client's attorney their communication may not be protected by the attorney-client privilege, and the QI may not be subject to the rules of ethics that govern attorneys.

Qualified intermediaries will become disqualified if their advice extends beyond advice with respect to exchanges intended to qualify for section 1031 nonrecognition.[10] The QI rules do not establish the parameters of what constitutes advice with respect to an exchange intended to qualify for section 1031 nonrecognition, so one cannot know with certainty if a QI crosses that line. If the advice is limited to the identification rules and the identification and exchange periods, then most observers would agree that the advice is with respect to an exchange intended to qualify for section 1031 non-recognition. If the advice relates to whether a TIC is a partnership or whether a drop-and-swap qualifies for non-recognition on both the distribution and the exchange, then the advice may cross the line and relate to classification of an arrangement and tax treatment of a partnership transaction. If that happens, then the QI safe harbor could cease to apply, and the exchange may not qualify for nonrecognition.

To avoid those problems and ensure that all aspects of a section 1031 are properly considered and applied, recommend that your client hire a section 1031 expert to assist with the exchange. Even when the exchange seems simple, if the dollars justify hiring an expert, don't take chances—get an extra set of expert eyes to review the exchange. It can't hurt to have a set of trained eyes review every aspect of the exchange. If the transaction is complex, definitely suggest that your client enlist expert help to assist with planning and executing the transaction. The cost of such help will be slight compared to the cost of defending problems that arise from oversight or neglect of important issues.

Conclusion

Section 1031 is a great tax-saving mechanism and section 1031 exchanges are ubiquitous. Real estate attorneys are on the front lines of exchanges. They should be mindful of situations that lend themselves to section 1031 treatment and help their clients understand the benefits of section 1031 deferral. Real estate attorneys should also be aware of issues that come up in section 1031 exchanges and be prepared to handle those issues or bring in tax specialists to help with those matters. Interesting and perplexing issues can arise even in what appear to be straightforward, simple exchanges. By being mindful of the 20 issues discussed in this article, real estate attorneys can help reduce the risk of overlooking a relevant issue or matter and help ensure that an intended exchange obtains the tax goals the exchanger is pursuing.

Notes

1 See Bradley T. Borden, "20 Things Real Estate Attorneys Can Do To Not Mess Up a Section 1031 Exchange (Part 1 Items 1-10)," in the May issue of The Practical Tax Lawyer.

2 For an in-depth discussion of extensions of the section 1031 periods, see Bradley T. Borden, "Universal Deadline Extensions Draw Attention to Section 1031 Periods," 167 Tax Notes Fed. 603 (Apr. 27, 2020). See also American Bar Association Section of Taxation, "ABA Tax Section Follows Up on Preliminary COVID-19 Remarks," 2020 TNTF 85-21 (Apr. 29, 2020); Letter from Real Estate Coalition Requesting Clarification of Disaster Relief for § 1031 Exchanges (Apr. 20, 2020), available at https://v6k8u5d3.stackpathcdn.com/wp-content/uploads/2020/04/LKE-Coalition-letter-to-Treasury-IRS-re-Notice-2020-23-4.20.20.pdf?x44329..

3 See Kristen A. Parillo, "FAQ Coming on Like-Kind Exchange Extensions," Tax Notes Federal, Apr. 20, 2020, p. 527.

4 For an in-depth discussion of those cases, see Bradley T. Borden, "Section 1031 Drop-and-Swaps Thirty Years after Magneson," 19 J. Passthrough Ent. 11 (Jan.-Feb. 2016).

5 See I.R.C. § 355; Treas. Reg. § 1.355-1, -2.

6 See Bradley T. Borden, 20 Things Real Estate Attorneys Can Do To Not Mess Up a Section 1031 Exchange (Part 1 Items 1-10), supra; "Build-to-Suit Ruling Breaks New Ground for Taxpayers Seeking Swap Treatment," 98 J. Tax'n 22 (Jan. 2003) (with Alan S. Lederman and Glenn Spear).

7 See "Accounting for Pre-Transfer Development in Bramblett Transactions," 41 Real Est. Tax'n 162 (3rd Quarter, 2014) (with Matthew E. Rappaport); "A Case for Simpler Gain Bifurcation for Real Estate Developers," 16 Fla. Tax Rev. 279 (2014) (with Nathan R. Brown & E. John Wagner, II).

8 See I.R.C. 7508A; Notice 2020-23, 2020-18 I.R.B. 1; Rev. Proc. 2018-58, 2018-50 I.R.B. 990.

9 See id.

10 See Treas. Reg. § 1.1031(k)-1(k).

WHAT TAX COUNSEL NEED TO KNOW ABOUT A FUNCTIONAL ANALYSIS

ROBERT F. REILLY, CPA, is a managing director of Willamette Management Associates. His practice includes business valuation, forensic analysis, and financial opinion services. Robert has performed the following types of valuation and economic analyses: economic event analyses, merger and acquisition valuations, divestiture and spin-off valuations, solvency and insolvency analyses, fairness and adequacy opinions, reasonably equivalent value analyses, ESOP formation and adequate consideration analyses, private inurement/excess benefit/intermediate sanctions opinions, acquisition purchase accounting allocations, reasonableness of compensation analyses, restructuring and reorganization analyses, tangible property/intangible property intercompany transfer price analyses, and lost profits/reasonable royalty/cost to cure economic damages analyses.

Tax counsel are often involved with their client's intercompany transfer price analysis. This is true whether the transfer price analysis is performed for federal tax purposes (for multinational clients) or for state tax purposes (for multistate clients). This is true whether the client's transfer price analysis is performed for tax planning, compliance, or controversy purposes. This discussion relates to one component of every transfer price analysis: the functional analysis.

In addition, tax counsel are often involved in valuations of the client's private businesses, securities, or property—with the valuations performed for income tax, gift and estate tax, property tax, or other taxation purposes. Also, tax counsel may also be involved in the taxation aspects of a client's damages measurement. A functional analysis is also one component of a valuation analysis and a damages analysis.

A functional analysis is one component of a transfer price analysis related to the intercompany transfer of tangible property, intangible property, or services. An intercompany transfer is a transfer between entities that are under common control. Such entities are often referred to as related parties. Such entities are also sometimes referred to as associated parties. A typical example of entities that are under common control would be two wholly owned subsidiaries (say, one domestic and one foreign) of the same multinational parent corporation.

A functional analysis is often applied for purposes of assessing the comparability of the subject entity to selected guideline or benchmark entities. These guideline or benchmark entities could be comparable companies, securities, or properties (including tangible property and intangible property). Many observers immediately think of a functional analysis within the context of the allocation of income and deductions among taxpayers for federal income tax purposes. The performance of a functional analysis is certainly relevant in this context. Also, as will be described in this discussion, the regulations related to Internal Revenue Code section 482 explain the application of a functional analysis for purposes of determining reliability. As will be discussed, a functional analysis is certainly relevant to an intercompany transfer price determination made for purposes of section 482 compliance.

In addition to transfer price analysis, a functional analysis is also relevant within the context of a value estimation and a damages measurement. For purposes of this discussion, a value estimate includes the valuation of privately owned companies, closely held securities, tangible assets, and intangible assets. In addition to taxation purposes, such valuations could be developed for transaction, financing, accounting, litigation, or other purposes. For

purposes of this discussion, a damages measurement includes the quantification of damages related to business entities, business ownership interests, tangible assets, and intangible assets. Such a damages measurement could relate to an injured party's damages sustained with regard to a tort claim or a breach of contract claim.

Such valuation, damages, and transfer price analyses are often performed by valuation analysts, forensic accountants, economists, and other types of professionals. This discussion refers to all of these professionals collectively as "analysts." This article summarizes the application of a functional analysis in the development of a valuation, damages, or transfer price analysis. This discussion considers the following topics:

- What is (and what is not) a functional analysis;
- The reasons for the analyst to perform a functional analysis within the context of a valuation, damages, or transfer price analysis;
- The functional analysis impact on valuation estimates;
- The functional analysis impact on damages measurements;
- The functional analysis impact on transfer price determinations;
- The 12 steps of a functional analysis;
- Who should perform the functional analysis; and
- Documentation of the functional analysis.

This article summarizes what tax counsel need to know about the functional analysis within the context of developing a valuation, damages, or transfer price opinion.

What is functional analysis?

As mentioned above, many counsel initially think of a functional analysis within the context of an intercompany transfer price determination between the controlled entities of a taxpayer (often a multinational taxpayer) for section 482 compliance purposes. While there are broader applications of a functional analysis, the section 482 regulations do provide a definition of a functional analysis that is generally applicable for this discussion.

Regulation 1.482-1(d)(3)(i) relates to comparability issues related to the allocation of income and deductions among taxpayers. Specifically, this regulations section deals with the factors for determining comparability of transactions and companies. This regulation section describes a functional analysis as follows:

> (i) Functional analysis. Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the functions performed, and associated resources employed, by the taxpayers in each transaction. This comparison is based on a functional analysis that identifies and compares the economically significant activities undertaken, or to be undertaken, by the taxpayers in both controlled and uncontrolled transactions. A functional analysis should also include consideration of the resources that are employed, or to be employed, in conjunction with the activities undertaken, including consideration of the type of assets used, such as plant and equipment, or the use of valuable intangibles. A functional analysis is not a pricing method and does not itself determine the arm's length result for the controlled transaction under review. Functions that may need to be accounted for in determining the comparability of two transactions include —
>
> (A) Research and development;
>
> (B) Product design and engineering;
>
> (C) Manufacturing, production, and process engineering;
>
> (D) Product fabrication, extraction, and assembly;
>
> (E) Purchasing and materials management;
>
> (F) Marketing and distribution functions, including inventory management, warranty administration, and advertising activities;

(G) Transportation and warehousing; and

(H) Managerial, legal, accounting and finance, credit and collection, training and personal management services.

While this regulation lists eight functions, it does not imply that the eight-item list is exhaustive. Rather, the regulation section indicates that the factors to consider "include" the eight listed functions. In addition, the regulation does not imply that the eight listed factors cannot be disaggregated or rearranged.

For the subject entity, a functional analysis basically considers the following topics:

- What products and services are offered to customers or clients (and how are those products and services designed or developed);
- What is the source of supply of the materials, labor, and overhead that is needed to produce those products and services (including sourcing dependence and sourcing logistics issues);
- How the products and services are manufactured or otherwise produced;
- How the products and services are differentiated, promoted, priced, and sold (including advertising and branding issues);
- How the inventory of products and services (including raw materials, work in process, and finished goods/services) are created, packaged, and stored;
- How the products and services are delivered (including shipping, transportation, and other delivery logistics issues);
- What assets are utilized to perform the functions within the business entity (including working capital assets, tangible assets, and intangible assets);
- How profits are earned in the business enterprise (including the cost/volume/profit relationships with regard to both production/service creation cost of sales and production/service delivery revenue recognition);
- How the accounting, finance, human resources, management information, marketing, sales, and other administrative activities operate within the subject entity; and
- How the subject entity is organized, managed, and capitalized (legally and administratively), including both (a) the relationship between the entity owners and the entity operators/managers and (b) the relationship between the entity and its sources of capital.

There are various financial, competitive, and operational analyses that may be components of the functional analysis. There are also some types of financial, economic, and industry analysis that are not really components of the functional analysis. These considerations of what are components—and what are not components—of the functional analysis are summarized next.

Considerations that are components of the functional analysis

Exhibit 1 presents a listing of the typical considerations in the performance of a functional analysis. This Exhibit 1 list is not intended to disagree with or to replace the eight factors listed in Regulation 1.482-1(d)(3)(i). Rather, the Exhibit 1 list is intended to expand on and to clarify the Regulation 1.482-1(d)(3)(i) list. Exhibit 1 is presented so as to serve as a checklist of functional analysis considerations for tax counsel when working with an analyst to develop a valuation, damages, or transfer price opinion.

Depending on the type of analysis being developed, the Exhibit 1 considerations may be used by tax counsel and the analyst to develop an understanding of the subject entity, ownership interest, or property. The Exhibit 1 considerations may also be used to compare the functions performed, assets employed, and risks assumed between two controlled entities under common ownership. Also, the Exhibit 1 considerations may be used to compare the functions performed, assets employed, and risks assumed between a controlled transaction and an uncontrolled transaction—particularly

within the context of an intercompany transfer price determination.

Considerations that are not substitutes for a functional analysis

As Exhibit 1 implies, there may be many components to the assessment of the functions performed, assets employed, or risks assumed. The following analyses may also be performed as part of a valuation, damages, or transfer price analysis. And, the following analyses may be considered as a part of—or a component of—a functional analysis. However, the following analyses are not a substitute for a functional analysis of the subject entity, ownership interest, or tangible/intangible property:

- Historical financial statement ratio or trendline analysis;
- State of the regional or national economy analysis;
- State of the subject industry (or the subject profession) analysis;
- Acquisition due diligence analysis;
- Quality of earnings analysis;
- SWOT analysis;
- History and description of the subject entity, ownership interest, or property; and
- Selection (and analysis) of guideline public companies or guideline merger and acquisition transactions or guideline royalty rates.

Each of the above analyses have a place in a business or property valuation, damages, or transfer price analysis. However, each of the above analyses is different than a functional analysis of the subject entity, ownership interest, or property.

Reasons to perform a functional analysis

Whether the counsel's assignment for the analyst is a value estimate, damages measurement, or transfer price determination, the reasons for conducting a functional analysis are pretty much the same.

The first reason to conduct a functional analysis is to familiarize the analyst with the subject entity, ownership interest, or tangible/intangible property. The research required and the diligence necessary to conduct the functional analysis results in the analyst developing both a broad and a deep understanding of the subject of the analysis. By performing the functional analysis, the analyst better understands how the subject works.

The second reason to conduct a functional analysis is to allow the analyst to assess comparability. The comparability assessment may allow the analyst to:

- Identify and select comparable companies, comparable transactions, comparable licenses, or other comparable transfers;
- Compare and contrast the functions of two related party (or associated) entities that are under common ownership (i.e., two controlled parties);
- Compare and contrast a controlled transaction with one or more uncontrolled (arm's-length) transactions;
- Make normalization adjustments to comparable companies, transactions, and licenses to make them more comparable to the analysis subject; and
- Make comparisons of the conditions in transactions between related parties—that is, the controlled transactions—with the conditions in comparable transactions between unrelated (or arm's-length) parties—that is, the uncontrolled transactions.

The third reason to conduct a functional analysis is to allow the analyst to assess the relative contribution of the various functions performed either within the subject entity or between the related (or associated) parties in a controlled transaction.

The fourth reason to conduct a functional analysis is to allow the analyst to identify the various assets that are used in the operation of the subject entity or in the conduct of the controlled transaction. These assets are employed to perform the various

functions associated with the subject entity. The assets considered in the functional analysis may include working capital accounts, tangible assets (real estate and tangible personal property), and intangible assets.

The fifth reason to conduct a functional analysis is to allow the analyst to identify the risks that are being assumed by the subject entity. A significant portion of the return earned by the entity's operations is due to the risks assumed by the entity. The functional analysis allows the analyst to compare these risks: (i) within the subject entity; (ii) between the subject entity and the selected comparable companies, transactions, and licenses; and (iii) between related party (or associated) entities in a controlled transaction.

Each of these five reasons will assist the analyst—and the tax counsel— in the development of the valuation, the damages measurement, or the transfer price determination.

Functional analysis impact on the valuation estimate

The functional analysis allows the analyst to understand the value creation within the subject entity. While the functional analysis is primarily considered to be a procedure for assessing—and adjusting for—comparability, the functional analysis does not only impact the market approach to business or property valuation. There are comparability considerations in all generally accepted valuation approaches.

The three generally accepted approaches to value a business or business ownership interest are the income approach, the market approach, and the asset-based approach. The three generally accepted approaches to value a tangible property or an intangible property are the income approach, the market approach, and the cost approach.

In the income approach, the functional analysis informs the analyst with regard to:

- Revenue projections;
- Expense projections;
- Investment projections;
- Present value discount rate components; and
- Expected long-term growth rate considerations.

In the market approach, the functional analysis informs the analyst with regard to:

- Normalizing the historical financial or operational results of the subject entity or property;
- Selecting comparable (or guideline or benchmark) companies, transactions, or licenses;
- Adjusting/normalizing the historical financial or operational results of the comparable companies, transactions, or licenses;
- Selecting the adjusted pricing multiples that were extracted from the comparable companies, transactions, or licenses; and
- Applying the selected market-derived pricing multiples to the subject entity, ownership interest, or property.

In the asset-based approach, the functional analysis informs the analyst with regard to the:

- Valuation of the tangible assets;
- Existence of the identifiable intangible assets;
- Applicable valuation variables (including useful economic life) to apply to the identifiable intangible assets;
- Capitalized excess earnings method valuation of any goodwill; and
- Valuation of the liabilities—and, particularly, contingent liabilities.

In the cost approach, the functional analysis informs the analyst with regard to the:

- Measurement of useful economic life—for both tangible property and intangible property;
- Identification and measurement of functional obsolescence (including the technological obsolescence component) of tangible property;

- Identification and measurement of economic obsolescence of tangible property;
- Normalization of the property owner's financial and operational metrics—particularly with regard to intangible property; and
- Selection of the valuation variables to perform the capitalized income loss method to measure economic obsolescence for intangible property.

As indicated above, the functional analysis has applications to all of the generally accepted business valuation approaches and property valuation approaches.

Functional analysis impact on damages measurements

Counsel often ask the analyst to identify and measure damages related to businesses, business ownership interests, tangible property, or intangible property. These damages are often caused by a wrongful action. The wrongful action could relate to a breach of some type of contractual agreement or a tortious action. The contract could include any type of merger or acquisition contract, commercial goods or services contract, license, lease, franchise, employment or services agreement, noncompete/nonsolicitation agreement, or other commercial contract. The tort could include a breach of a trustee's (or other party's) fiduciary duty, lender liability duty, duty to shareholders, or any other type of duty.

In the measurement of the business or property damages, analysts often consider these generally accepted damages measurement methods:

- Lost profits;
- Reasonable royalty rate; and
- Cost to cure (including lost business or property value).

The functional analysis informs the analyst throughout the damages measurement assignments.

First, the functional analysis helps the analyst identify the component of the business or property that was damaged. The functional analysis may not identify the damages event or the party who conducted the wrongful action. But, the functional analysis should help to identify what entity/property functions were damaged, the relative importance of those damaged functions to the subject entity/property, and the value creation due to the functions—or, in this case, the value destruction due to any damage to those functions.

Second, the functional analysis should help to identify the entity/property's normal financial or operational variables—that is, the entity/property's metrics "before" or "without" the damages event. The analyst can compare those normal financial or operational variables to the entity/property's current metrics—that is, "after" or "with" the damages event. The differences in these metrics before and after (or without and with) damages is one measure of lost profits. In particular, the functional analysis may help the analyst to develop (and to test the reasonableness of) any damages projection variables—including revenue, expenses (fixed and variable), investments, and other prospective financial variables.

Third, the functional analysis may help the analyst to identify when the damages impact started (i.e., the beginning of the damages period), the term of the damages period, and when the damages impact ended—if it did end (i.e., the end of the damages period).

Fourth, the functional analysis may help the analyst to identify and measure the impact of any mitigation efforts in response to the damages event.

Fifth, the functional analysis may help the analyst to identify, compare, normalize, select, and apply arm's-length license agreement royalty rates in a reasonable royalty rate damages analysis.

Sixth, the functional analysis may help the analyst to identify the costs to cure the impact of the damages event. This is because such an analysis may identify the particular entity/property functions that were damaged—to allow the analyst to estimate the cost to cure (i.e., repair) the damaged function.

Seventh, the functional analysis may inform the analyst's selection of the historical valuation variables to develop the "before" business or property valuation. The current (post-damages event) application of the functional analysis may inform the analyst's selection of the post-damages valuation variables to develop the "after" business or property valuation. The difference in the "before" value and the "after" value is one indication of the lost business value or property value.

The development of the functional analysis may also help the analyst to identify all of the entity's operational components and tangible/intangible assets that were impacted by the damages event. And, the performance of the functional analysis may help the analyst to quantify the lost profits, reasonable royalty rate, or cost to cure related to the business or property damages.

Functional analysis impact on transfer price determination

As mentioned above, a functional analysis is an important procedure in an intercompany transfer price analysis. The transfer price analysis helps to identify the value chain. A value chain separates a business into a series of value-generating functions. This value chain helps provide the analyst with a foundation from which to identify the functions performed, the assets employed, and the risks assumed. This foundation helps the analyst to understand the activities that create value in the subject entity, ownership interest, or property.

As mentioned above, regulation 1.482-1 provides an introduction to the allocation of income and deductions among taxpayers. Regulation 1.482-1(d)(3)(i) describes a functional analysis within the context of the factors for determining the comparability of transactions.

Regulation 1.482-2 includes guidance related to the determination of taxable income in specific situations. These specific situations include:

- Loans or advances;
- The performance of services for another;
- The use of tangible property; and
- The transfer of property.

Regulation 1.482-3 describes the methods to determine taxable income with a transfer of tangible property. These methods for determining an arm's-length transfer price with regard to tangible property include:

- The comparable uncontrolled price method;
- The resale price method;
- The cost plus method; and
- Unspecified methods.

Regulation 1.482-3(c)(3)(ii)(A) discusses functional comparability with regard to the resale price method. Specifically, this regulation section deals with comparability and reliability considerations within the application of the resale price method.

Regulation 1.482-3(d)(3)(ii)(A) discusses functional comparability with regard to the cost plus method. Specifically, this regulation section deals with comparability and reliability consideration within the application of the cost plus method.

Regulation 1.482-4 describes the methods to determine taxable income with regard to the transfer of intangible property. First, this regulation provides a description of what is intangible property. Second, this regulation describes the following methods for determining an arm's-length transfer price with regard to intangible property:

- Comparable uncontrolled transaction method; and
- Unspecified methods.

Regulation 1.482-5 describes the comparable profits method. Specifically, regulation 1.482-5(c)(2)(ii) discusses functional, risk, and resources comparability. This regulation section presents these factors within the context of comparability and reliability considerations in the application of the comparable profits method.

Regulation 1.482-6 describes the application of the profit split method. This regulation provides guidance with regard to the:

- Comparable profit split method; and
- Residual profit split method.

Regulation 1.482-7 relates to cost sharing arrangements. Regulation 1.482-8 provides examples of the application of the best method rule.

Regulation 1.482-9 relates to the determination of an arm's-length transfer price related to controlled services transactions. Regulation 1.482-9(d)(3)(ii)(A) describes functional comparability. This regulation section discusses comparability and reliability considerations within the context of the application of the gross services margin method. Regulation 1.482-9(c)(3)(ii)(A) also describes functional comparability. This regulation section discusses comparability and reliability considerations within the context of the application of the cost of services plus method.

In all cases, the regulations discuss the functional analysis within the context of assessing—and adjusting for—comparability. These assessments—and adjustments—are made to the subject entity or property or between the related (or associated) parties to the controlled transaction. These assessments and adjustments are based on the:

- Relative contribution of the various functions performed;
- Assets (both tangible and intangible) used to perform these functions; and
- Risks assumed by the subject entity or the related parties.

The 12 steps of the functional analysis

As mentioned above, there are many considerations related to the development of a functional analysis. Counsel should be aware that these many considerations are equally relevant whether the functional analysis is developed for valuation, damages, or transfer price purposes. And, to reiterate, Exhibit 1 was intended to only present a partial listing of typical analyst considerations. Exhibit 1 does not present a comprehensive list of all analyst considerations. However, all of the analyst considerations or procedures may be categorized into what this discussion refers to as the 12 steps of the functional analysis.

These 12 steps do not necessarily have to be performed in the order or sequence presented below. However, the following listing of steps is presented in a logical sequence. Some of the steps may be performed simultaneously. Some of the steps may be performed out of order. However, this discussion recommends that all of the 12 steps should be developed, to a greater or less extent, before the functional analysis is considered to be complete.

It is important for counsel to recognize that each so-called "step" represents a category or grouping of many analyst procedures and investigations. These categories of procedures are called "steps" to remind the analyst to proceed from the initial understanding of the subject entity to the final assessment of the risks assumed by that subject entity. After completing all of these 12 steps, the analyst should have developed—and documented—an understanding of the subject entity's functions performed, assets employed, and risks assumed.

These 12 steps—or categories or groupings of analyst procedures—are listed in Exhibit 2.

The first 10 steps on Exhibit 2 primarily relate to the functions performed at the subject entity. Step 11 on Exhibit 2 primarily relates to the assets employed at the subject entity. Step 12 on Exhibit 2 primarily relates to the risks assumed by the subject entity.

For purposes of this discussion and for purposes of applying Exhibit 2, the phrase the "subject entity" encompasses an individual subject entity, an ownership interest in such an entity, the tangible property or intangible property of such an entity, or two related parties performing associated functions (and controlled transactions) as part of a common ownership entity.

The type of analyst to conduct the functional analysis

Counsel should be aware that there is no specific guidance or limitation as to what type of professional should perform the functional analysis. Similarly, there is no specific guidance or limitation as to what type of professional should perform a valuation analysis, damages measurement, or transfer price determination. Some counsel have referred to the functional analysis as an economic analysis. It is true that the functional analysis includes the consideration of the inputs and the outputs of a subject entity. Similarly, the functional analysis includes the consideration of the cost/volume/profit relationships of a subject entity. And, these considerations involve the application of microeconomics principles. But, by that general definition, all valuation, damages, and transfer price analyses involve the application of microeconomics principles.

The Internal Revenue Manual doesn't address the question of what type of professional should perform the functional analysis. However, the Internal Revenue Manual does provide perspective on the various types of professionals who may be involved in the transfer price analysis related to intangible property. Section 4.61.3.4.6 of the Internal Revenue Manual relates to "Transfers of Intangible Property" and provides the following perspective related to intangible property comparable uncontrolled transactions and arm's-length license royalty rate analyses:

7. Determining arm's length royalty amounts for controlled transfers of intangibles may require the support of the following specialists:

a. Economists

b. Engineers

c. Industry experts

d. Experts in the field of licensing intangibles

e. Marketing experts

f. Other inside and outside experts

The fact that economists are mentioned first in the above listing may be one reason why some counsel associate economists with intercompany transfer price analyses. While the above list specifically relates to intangible property transfer prices, it is reasonable to conclude that any of the above-mentioned categories of professionals could perform a functional analysis.

In addition to the Internal Revenue Manual listing of types of professionals, accountants—and particularly forensic accountants—have particular experience and expertise with regard to all three disciplines of valuation, damages measurement, and transfer price determination. All three of these disciplines require a thorough understanding of generally accepted accounting principles (GAAP), income tax accounting principles, accounting systems and procedures, and the analysis of financial statements and other financial documents. In addition, most forensic accountants have a breadth and depth of experience related to business operations, data gathering and special investigations, and due diligence procedures and associated documentation.

Although not specifically mentioned in the Internal Revenue Manual, valuation analysts have specialized training and experience that would qualify them to perform the functional analysis. Valuation analysts routinely apply microeconomics principles. Valuation analysts have to understand both GAAP accounting and income tax accounting. Most valuation analysts are skilled at data gathering, interviewing and investigative techniques, and due diligence procedures. Most importantly, valuation analysts have to develop both broad and deep skills with regard to performing, interpreting, and applying comparability analyses.

That is, most valuation analysts are experienced with regard to identifying, adjusting, normalizing, extracting pricing data from, and applying pricing multiples derived from comparables. Such comparables could include comparable companies, comparable business interests, comparable tangible property, and comparable intangible property. And,

the comparable transactions could include sales, leases, licenses, or other types of transfers.

Valuation analysts have experience and expertise in assessing and adjusting for comparability—a fundamental component of the functional analysis. In addition, like certified public accountants, valuation analysts pursue specialized training based on a standardized body of knowledge, are tested and credentialed based on that standardized body of knowledge, must pursue continuing professional education requirements, and comply with documented ethics standards and other professional standards. Many of the other types of professionals included in the above Internal Revenue Manual list do not meet these various qualifications.

Overall, and more important than a particular professional credential or academic benchmark, the appropriate type of professional to perform the functional analysis is a professional who understands how that functional analysis can be applied in the development of the value estimate, the damages measurement, or the transfer price determination.

Documentation of the functional analysis

As with the type of professional who performs the functional analysis, there is no specific guidance or requirement related to the documentation of the functional analysis. The following recommendations are presented as best practices (and not as professional standards or professional organization requirements) related to functional analysis within the context of a valuation or a damages measure or a transfer price analysis. This best practices guidance assumes that the analyst prepares some type of written or oral report to document the development and the conclusion of the subject analysis.

As a general best practice, both the analyst's work papers and the analyst's report (whether for valuation or damages or transfer price) should include adequate documentation of:

- The selection of—and the rejection of—all relevant considerations and steps—and the reasons for that selection and/or rejection;
- The data gathering process applied with regard to all of the selected considerations;
- The selection of (and the rejection of—and the reasons therefor) all data sources;
- A listing of all documents generally considered and of all documents specifically relied on in the functional analysis, including a description of the source of each document; copies of all of the documents relied on by the analyst should be included in the work paper file;
- All due diligence procedures performed (including the conduct of any subject entity management interviews or any third-party interviews);
- The schedules and exhibits prepared to summarize all of the quantitative comparability and other analyses performed;
- The analyst's assessment of each consideration developed—documented with a commentary, description, flowchart, or other explanation;
- The analyst's conclusion related to each of the 12 steps (or the 12 categories of procedures)—documented with a commentary, description, flowchart, or other explanation;
- A listing of each of the qualitative or quantitative factors leading up to the analyst's conclusions regarding these functional analysis components: (i) functions performed by the subject entity—and the relative importance thereof, (ii) assets employed by the subject entity—both tangible and intangible assets, and (iii) risks assumed with regard to the subject entity's operations;
- A narrative summary and conclusion describing the analyst's functional analysis opinion, including a conclusory discussion of (i) functions performed, (ii) assets employed, and (iii) risks assumed.

Also as a general best practice, analysts may become familiar with the analysis documentation and reporting procedures describe in:

- The mandatory performance framework; and

- The application of the mandatory performance framework.

These best practices documentation guidelines were developed for the Certified in Entity and Intangibles Valuation (CEIV) professional credential program developed by the Corporate and Intangibles Valuation Organization, LLC. These best practices guidelines are only "mandatory" for CEIV credential holders when they are performing fair value measurement valuations. However, while not mandatory for non-CEIV analysts, these guidelines do provide "best practices" guidance with regard to the analysis documentation and reporting. Such best practices guidance with regard to the functional analysis may also be applied generally to all aspects of the valuation, damages, or transfer price analysis.

Counsel should be aware that there are various checklists available with regard to the performance of a functional analysis—particularly within the context of an intercompany transfer price determination. For example, the Internal Revenue Manual includes a "Transfer Pricing Functional Analysis Questionnaire" as Exhibit 4.61.3-4 of the manual. The use of such a checklist is a convenient resource for the analyst, particularly for purposes of completing a functional analysis with regard to section 482 compliance.

However, counsel should also be aware that any checklist or questionnaire only documents what the analyst did—that is, the procedures the analyst performed. While such a listing of procedures performed is an important component of the functional analysis documentation, it does not provide a complete set of the functional analysis documentation. The work papers and the report should not only describe the procedures that the analyst performed—but also what conclusions the analyst developed after performing those procedures. In other words, the work papers and the report should document the analyst's thought process and rationale.

Ideally, the functional analysis work papers and report should be sufficient to allow another analyst (or the tax counsel) to:

- Replicate the data gathered, the procedures performed, and the considerations made;
- Duplicate the analyst's thought process and decision-making; and
- Re-create the analyst's opinions and conclusions.

A well-documented set of work papers and a well-documented report (written or oral) will accomplish these objectives related to the functional analysis. These documentation objectives apply to a valuation or a damages or transfer price analysis.

CONCLUSION

Tax counsel are often involved in a client's intercompany transfer price analysis. This is true whether that analysis is performed for tax planning, compliance, or controversy purposes. Tax counsel may also become involved in the client's valuation analysis—whether that analysis is prepared for taxation or other purposes. Tax counsel may become involved with the client's damages analysis—whether the client is the damaged party or the wrongful party. Tax counsel should be generally familiar with one component of each of these business analyses—i.e., the functional analysis component.

Many tax counsel associate a functional analysis with a transfer price determination, and particularly with a transfer price analysis performed for section 482 compliance purposes. section 482 relates to the allocation of income and deductions related to the intercompany transfers of tangible property, intangible property, or services.

A functional analysis is one important component of any transfer price analysis. However, tax counsel should understand that a functional analysis is also an important component of a valuation and of a damages measurement. In fact, a functional analysis is relevant any time the analyst needs to thoroughly understand the subject entity—and particularly to understand the value drivers that impact the subject entity.

A functional analysis is relevant when the analyst needs to understand both the various functions

that are performed at the entity and the relative importance of these functions, the various assets employed at the entity—including the working capital assets, the tangible assets, and the intangible assets, and the various risks assumed by the entity operations—including operational risks, financial risks, dependence risks, litigation risks, and other risks. All of these factors are important to any analyst performing a valuation, damages, or transfer price analysis.

This discussion considered what is (and what is not) a functional analysis, and this discussion considered the reasons to perform the functional analysis. This discussion summarized the applications of a functional analysis within a valuation, damages, or transfer price determination. And, this discussion summarized the many considerations made by the analyst into what was called the 12 steps of conducting the functional analysis.

Finally, this discussion considered the various types (or categories) of professionals who may be involved in developing the functional analysis. This article described the documentation guidelines related to the functional analysis. These documentation guidelines relate to both the analyst's work papers and the analyst's report—both written and oral. And finally, this discussion summarized what tax counsel need to know about the functional analysis within the context of developing a valuation, damages, or transfer price opinion.

EXHIBIT 1

Functional Analysis Considerations Related to Valuation, Damages, or Transfer Price Analyses

I. ORGANIZATION CONSIDERATIONS

A. Type of entity

1. Description of whether the subject is a business entity, ownership interest, tangible property, or intangible property
2. Description and documentation of ownership of the subject entity
3. Description of legal structure of the subject entity
4. Description of tax structure of the subject entity
5. Description of any ownership relationships with related parties, applicable parties, or other common ownership
6. Description of corporate governance (e.g., board of directors)
7. Description of operational executive or management structure (e.g., management organization chart)
8. Description of operational functions structure (e.g., departmental organization chart)
9. Description and locations of owned tangible property
10. Description and locations of leased tangible property

B. Entity documents

1. Organization documents (e.g., articles of the corporation)
2. Operational documents (e.g., partnership agreements, member agreements)
3. Entity ownership documents (e.g., shareholder agreements, buy/sell agreements)
4. Asset ownership documents (e.g., deeds, legal descriptions, licenses, leases)
5. Entity transferability documents (e.g., franchise agreement restrictions, regulated industry considerations)
6. Ownership interest transferability considerations (e.g., security puts and calls)
7. Recent board of directors or executive/management committee minutes
8. Copies of any business or operating permits or certificates
9. Copies of any inbound or outbound intellectual property licenses
10. Copies of any joint venture, joint development, joint commercialization, etc., agreements

11. List of registrations of all intellectual property, including domestic and international patents, copyrights, and trademarks
12. Copies of documents that illustrate the entity's use of domestic and international patents, copyrights, trademarks, and trade names

II. OPERATIONS CONSIDERATIONS

A. Operational functions

1. Description of products produced and services provided
2. Description of how products and services are designed, developed, or engineered
3. Description of raw materials inputs (sources, costs, and logistics of supply and supply chain risks)
4. Description of labor inputs (sources, costs, and logistics of supply and supply chain risks)
5. Description of overhead (operating expense inputs) (sources, costs, and logistics of supply and supply chain risks)
6. Description of product manufacturing or services production process
7. Description of production scheduling and quality control procedures
8. Description of product warehousing and in-process services storage
9. Description of product warranty and product return risk elements
10. Description of products and services shipping and delivery logistics
11. Description of how intellectual property (patents, copyrights, trademarks, and trade secrets) are developed, documented, and registered
12. Description of how intellectual property (patents, copyrights, trademarks, and trade secrets) are commercialized and protected

B. Administrative functions

1. Description of accounting functions
2. Description of receivables/cash collection function and payables/cash disbursement function
3. Description of treasury (cash management and banking relationship) function
4. Description of capitalization, capital structure, and financing functions
5. Description of products/services design and engineering function
6. Description of production engineering/services delivery efficiency function
7. Description of advertising and market research function
8. Description of packaging and branding function
9. Description of human resources, recruiting, training, benefits function
10. Description of general counsel function
11. Description of information technology, management information function
12. Description of regulatory compliance and other compliance functions

C. Competition and competitive position functions

1. Listing and description of principal competitors
2. Approximate size of principal competitors
3. Ranking of principal competitors by market share and relative market share
4. Products/services features differentiation with competitors
5. Products/services pricing differentiation with competitors
6. Products/services distribution differentiation with competitors
7. Products/services intellectual property differentiation with competitors
8. Description of total market size
9. Description of total market growth rate
10. Description of how customers or clients use the entity's products/services

D. Risk/expected return considerations

1. Description of materials source of supply risk
2. Description of labor source and supply risk
3. Description of operating leverage (fixed costs coverage) risk
4. Description of financing leverage (debt service coverage) risk
5. Description of tangible property risk
6. Description of environmental risk
7. Description of litigation risk
8. Description of intellectual property risk
9. Description of customer concentration risk
10. Description of executive concentration risk
11. Description of regulatory change risk
12. Description of products/services liability risk

III. FINANCIAL CONSIDERATIONS

A. Accounting principles and financial statements

1. Descriptions of current accounting principles applied
2. Comparison of entity accounting principles to competitor accounting principles
3. Description of recent changes in accounting principles applied
4. Discussion of revenue recognition principles
5. Discussion of expense recognition principles
6. Discussion of taxation accrual and deferred tax principles
7. Discussion of tangible asset capitalization and depreciation principles
8. Discussion of intangible asset recognition principles
9. Discussion of liability recognition principles
10. Discussion of any adjustments to capital accounts
11. Discussion of cash flow statement working capital adjustments
12. Discussion of cash flow statement noncash revenue and expense account
13. Discussion of cash flow statement investment adjustments
14. Discussion of cash flow statement financing adjustments

B. Financial statement projection considerations

1. Description of the term (time period) of any financial projections
2. Description of the level of detail included in any financial projections
3. Description of financial projections development procedures
4. Description of financial projections review procedures
5. Comparison of financial projections to historical financial statements
6. Comparison of financial projections to guideline company financial projections
7. Comparison of financial projections to industry financial projections
8. Comparison of historical financial projections to historical financial statements for prior projection periods
9. Copies of any strategic plans or competitive analyses
10. Copies of any debt service payment projections (including any considerations of liquidity or solvency)

C. Valuation considerations

1. Description of the process for selecting guideline public companies
2. Procedures for assessing the subject entity comparability to guideline public companies
3. Procedures for adjusting the financial data of guideline public companies
4. Description of the process for selecting guideline M&A transactions

5. Procedures for assessing the comparability of the subject entity to guideline M&A transactions
6. Procedures for adjusting the financial data of guideline M&A transactions
7. Description of any recent offers to buy the entity or the entity's securities
8. Description of any recent sales (or other exchanges) of the subject entity or the entity's securities
9. Descriptions of any value indications (including historical development costs) of tangible real property and tangible personal property
10. Descriptions of any value indications (including historical development costs) of general commercial intangible assets and of intellectual property

IV. ASSETS EMPLOYED AND SWOT/ RISKS ASSUMED CONSIDERATIONS

A. Assets employed

1. Description of—and use of—cash and marketable securities
2. Description of—and use of—accounts receivable
3. Description of—and use of—prepaid expenses
4. Description of—and use of—inventory accounts
5. Description of—and use of—other current asset accounts
6. Description of—and use of—land and buildings
7. Description of—and use of—tangible personal property
8. Description of—and use of—other tangible assets
9. Description of—and use of—intellectual property assets
10. Description of—and use of—other identifiable intangible assets
11. Description of—and use of—intangible value in the nature of goodwill
12. Description of—and use of—nonoperating or investment assets
13. Description of—and use of—current liabilities
14. Description of—and use of—long-term interest-bearing debt
15. Description of—and use of—other long-term liabilities
16. Description of—and use of—contingent liabilities

B. SWOT and risks assumed considerations

1. List of principal competitive strengths
2. Description of how competitive strengths affect the entity's operating results
3. Description of how competitive strengths affect the entity's risks
4. List of the principal competitive weaknesses
5. Description of how competitive weaknesses affect the entity's operating results
6. Description of how competitive weaknesses affect the entity's risks
7. List of the principal competitive opportunities
8. Description of how competitive opportunities affect the entity's operating results
9. Description of how competitive opportunities affect the entity's risks
10. List of principal competitive threats
11. Description of how the principal competitive threats affect the entity's operating results
12. Description of how the principal competitive threats affect the entity's risks

EXHIBIT 2

12 Steps in the Performance of a Functional Analysis Related to a Valuation, Damages, or Transfer Price Conclusion

1. Gather and review all relevant entity legal documents. (This step includes documents regarding organization structure, legal firm, tax status, and owners—e.g., shareholder, partnership, LLC member—agreements).
2. Gather and review all relevant entity organization charts. (This step includes both personnel reporting charts and functional relationship clients and considers both entity governance procedures and quality, quantity, tenure, and experience of entity/function leaders).
3. Understand and document the products/services design, R&D, and products/services differentiation functions. (This step includes the assessment of how the entity's products or services are developed and how these products or services are intended to address their competition in the relevant marketplace).
4. Understand and document the materials, labor, and overhead procurement function. (This step includes consideration of how and when the entity procures all of its materials, labor, and overhead inputs—for entities in every type of industry or profession).
5. Understand and document the products/services production function. (This step includes the assessment of how the entity processes all of its material, labor, and overhead components to produce a product or a service—including the quality control of the products or services production).
6. Understand and document the inventory and products/services storage function. (This step includes both the in-process and finished inventory of goods and the in-process and finished inventory of services).
7. Understand and document the sales and marketing function. (This step includes the assessment of the products or services pricing, packaging, advertising, promotional, trademark development and protection, and other branding—on a stand-alone basis and in response to competitive products and services).
8. Understand and document the shipping and distribution logistics function. (This step includes consideration of how the products or services are delivered to the customer or client—including freight, insurance, returns, warranty and repairs, and other expenses).
9. Understand and document the accounting, finance, information systems, human resources, legal, and other administration functions. (This step includes the assessment of how: (i) information is generated and used throughout the organization; (ii) human resources are developed and administered; (iii) financial statements and operational documents are prepared and used; (iv) how cash management and treasury operations are performed; and (v) how the entity is capitalized with debt and equity capital sources).
10. Assess and document the entity's strategic position in comparison to competitors in an industry or profession. (This step includes: (i) measurement of the entity's market share/selective market share, market size, and market growth rate; (ii) evaluation of the entity's customer or client needs; and (iii) assessment of the entity's competitive strengths, weaknesses, opportunities, and threats).
11. Describe and document the assets used by the entity to perform the functions. (This step includes a listing, description, and assessment of relative importance/contribution of: (i) all working capital accounts; (ii) all tangible property types and accounts—owned and leased; and (iii) all general intangible property types; and accounts—owned and licensed, and (iv) all intellectual property types and accounts—owned and licensed).
12. Evaluate and document the risks assumed by the entity to perform the functions. (This step includes a listing, description, and assessment of all products/services liability, operating language, financial leverage, environmental, supply dependence, customer dependence, technology dependence, employee dependence, intellectual property dependence, tax litigation, commercial litigation, credit and collection, inventory control, property and casualty, foreign exchange, market/competitor, and other risks).

PROCEEDING WITH A VALUATION CASE INVOLVING CLOSELY HELD BUSINESS INTERESTS BEFORE THE UNITED STATES TAX COURT (PART 1)

JERALD DAVID AUGUST is Partner in Fox Rothschild LLP, in Philadelphia. Mr. August is Chair of the firm's International Taxation and Wealth Planning Practice Group. Jerry is a nationally recognized tax lawyer who advises clients on income tax matters, including foreign taxation of U.S. businesses and U.S. taxation of foreign businesses and investors. He frequently advises high net worth individuals, both U.S. and non-U.S. citizens and residents, on estate planning and taxation issues. Mr. August represents clients before the Internal Revenue Service, including trials before the U.S. Tax Court, the Court of Federal Claims, federal district courts and the Eleventh Circuit Court of Appeals, on various business and wealth tax matters as well as complex and serious tax compliance issues. He has also represented taxpayers in both income and estate tax cases at the state level. Jerry represented the Tax Section of the Florida Bar in filing an amicus curiae brief before the U.S. Supreme Court in a landmark tax case, O.C. Hubert Est., S. Ct., 97-1 USTC ¶60,261, 520 U.S. 93. Mr. August is a Life Sustaining Member of the prestigious American Law Institute (ALI) and regularly serves as program chair and speaker for ALI CLE federal tax webcasts and seminars on various topics involving federal taxation and is chair of the Editorial Board of the ALI's long-standing tax law journal, The Practical Tax Lawyer. For more than 30 years, he has served on the Board of Advisors of the New York University Federal Institute of Taxation. August has been a guest lecturer at the University of Pennsylvania Law School and the University of Pittsburgh School of Law, and a visiting professor on corporate income taxation at the Graduate Tax Program of the University of Florida School of Law. He has published more than 200 articles on partnership, corporate, and international taxation published by national professional journals, including the Florida Law Review, Corporate Taxation, Business Entities, Journal of Passthrough Entities and Tax Notes. He is a member of American College of Tax Counsel, the American College of Trust and Estate Counsel and the American Tax Policy Institute. He is admitted to practice in Pennsylvania, New York and Florida.

Editor's note: The following Prologue was written by the late Guy B. Maxfield, Professor Emeritus of Law at New York University School of Law. He earned a sterling national reputation in the field of income taxation and estate and gift taxation. He developed enormous experience planning estates for individuals with sizable assets as well as advising owners of closely held corporations on tax matters. Professor Maxfield was elected to the Order of the Coif and was Editor of the Michigan Law Review at the University of Michigan Law School, where he earned his Juris Doctorate. He received his Bachelor of Arts degree from Augustana College, and he was a highly regarded member of the New York State Bar. He was also admitted to the U.S. Tax Court and the U.S. District Court for the Southern District of New York. He was a member of the American Bar Association Section of Taxation, American College of Tax Counsel, American Law Institute, and New York State Bar Association Tax Section.

He was a Professor of Law at New York University School of Law for 43 years and in his final years attained the status of Professor of Law Emeritus. He was twice selected to teach a course dealing with estate and gift taxation before the National Office of the Internal Revenue Service. His academic subject areas included income taxation, tax procedure, and estate and gift taxation.

Professor Maxfield was a co-author of the treatise Federal Estate and Gift Taxation and published numerous articles in the International Tax Journal, the Journal of Taxation, the Michigan Law Review, the New York State Bar Association Journal, the New York University Annual Survey of American Law, the Tax Law Review, the Tax Lawyer, The Record, Trust

and Estates, and the New York University Institute on Federal Taxation.

Professor Maxwell was a decades-long mentor, frequent co-author, and all-time friend to the author of this article. Professor Maxwell's passing will be a great loss to our profession and to the American Law Institute. But his contributions will endure and continue to guide coming generations of tax practitioners. We salute his service and bow our heads in gratitude.

PROLOGUE BY PROFESSOR MAXWELL

There comes a time in the life of a tax lawyer when a client will ask, "What is it worth?" The question can be asked in a variety of situations, including the reshuffling of the family business, the planning of a complex estate (see notes 10-12 for a discussion of the consideration exception to sections 2036-2038 of the Code), or by simply making a gift to charity.

These issues, among many others, are discussed at length in the following article written by Jerald David August. You will find a very comprehensive analysis of the relevant case law and regulations. For example, the extremely complicated issue of the value of a minority interest is explored in depth (notes 56 et seq). Some readers may be surprised to learn that the hope-for discount may be treated as a premium item! (notes 90 et seq).

The valuation approach referred to as the "subtraction method" is also discussed (notes 79 et seq). The effect of the potential federal income tax that will be due at the disposition of a significant asset of the corporation caused by the repeal of the General Utility doctrine, is explored (notes 100 and following). In which jurisdiction to try the case is discussed as well. The Tax Court, District Court, or Court of Claims are available. Probably most taxpayers will choose the Tax Court since it is the only one of the three that will assume jurisdiction without requiring a payment in full of the tax.

A thorough and thoughtful analysis of the cost of being wrong on an evaluation issue imposed by section 6662-6664 is also fully discussed.

A reader will also find in this article an extremely comprehensive relevant analysis of the regulations and case law including many references to secondary authorities in determining the answer to the surprisingly difficult question, "What is it worth?"

INTRODUCTION BY JERALD DAVID AUGUST

The government and taxpayers frequently disagree on the fair market value of property for federal tax purposes, including in determining federal gift and estate taxes

This article, which will be published in two parts as part of a single comprehensive study of the subject, addresses the main factors and considerations in filing a petition with the United States Tax Court in challenging the Internal Revenue Service's proposed deficiency in income, gift, or estate tax, plus additions to tax in the form of an accuracy-related penalty, or penalties in some instances. There is, of course, the consequential interest owed or any finally agreed-to judicially determined amount of taxes and additions to tax as part of the assessment. As long as the fair market value of an interest in property is includible in the base of the applicable tax, is used to determine the amount of a charitable contribution, or is taken into account in computing the amount realized with respect to a sale or exchange or in determining basis, the government can be expected to carefully evaluate an appraisal of value or other determination of value set forth in a tax return, disclosure statement, or other filing by the taxpayer. It will further look at the objectivity, professional background, and experience as well as the independence of the appraiser or expert valuation witness.

The starting point or assumption is of course that the government will invariably object to the taxpayer's reported or subsequently advanced determination of the fair market value a particular asset, including the taxpayer's ownership interest in shares of stock or as a limited partner or member of an unincorporated entity taxed as a partnership. Frequently, the difference in valuation determinations by the Service and the taxpayer will be substantial. After all, one

should assume that small or relatively small disputes over fair market value can be resolved at the audit level or, if not, then before trial. Where agreement cannot be reached and the case moves up to appeals or docketed status, the pre-trial differences of the parties on the fair market value of ownership interests in a family limited partnership or corporation for gift or estate tax purposes may be re-evaluated and revised—which upon a second or third look can result in each party taking a more aggressive position, possibly causing the parties to have to prepare for trial but still entertain the thought of settlement. The pre-trial positions of either of the parties on the fair market value of a closely held business interest are not binding. But as the case continues to remain open and unresolved, the chances for litigation increase. Additional experts may be called upon by either or both parties for their testimony and valuation report to be admitted into evidence at trial. Perhaps a new expert and pre-trial deposition testimony may give each party the ability to leverage its position and perhaps increase the chances for settlement. Perhaps it will not have that effect for the Service, particularly when the resources and costs incurred by the Service increase. The government may in such instances feel it needs to make its case and let the ultimate fact-finder decide the question.

Another aspect of finding an additional appraiser or expert witness to support the taxpayer's position is that such new appraiser or expert, despite having perhaps greater professional credentials than the initial appraiser whose opinion of value was used in filing the relevant tax return, may not fully embrace or agree with the prior position on valuation of the taxpayer. That possibility is not just theoretical. It could indeed happen and, if it does, the taxpayer's bargaining position is weakened; at least that thought would occur to the taxpayer's tax counsel. Perhaps that new or additional appraiser should first be put under a Kovel agreement without issuing a written opinion first.[1] That would at least provide tax counsel and the client the opportunity to re-evaluate their position on valuation with the input (but not disclosure) of the valuation consultant's views and underlying analysis of the valuation issue. It must be remembered, however, that the additional appraiser cannot be put in a position to directly review and critique the other valuation reports prematurely in formulation of his "opinion." In the event the expert is called upon to testify, the expert's independence will be put in issue, which means, of course, that the government may find such expert to simply be an advocate for the taxpayer or even disqualify the expert from testifying.[2]

The same variance may frequently be found when the government's audit report is modified in its explanation to the statutory notice of deficiency or at a subsequent point prior to trial through the submission of new expert testimony on behalf of the respondent. Indeed, the amount in dispute may increase even though the government may have the burden of proof on the increased value sought over and above the value set forth in its notice of deficiency.

Given the vagaries involved in having the trial court, as fact-finder, "estimate" what a hypothetical willing buyer would pay a hypothetical willing seller for the closely held business interest on the applicable valuation date, the Tax Court encourages valuation disputes be resolved by the parties without litigation. The resolution of the valuation dispute without trial can of course occur through settlement discussions by the parties directly. It may also be conducted with the Tax Court's rules on alternate dispute resolution procedures such as arbitration or mediation.[3] What the parties could not resolve through audit, possible appeals review, and settlement negotiations before trial will be forgotten once the trial court is asked to make its finding of fact as to the value it determines under the "willing buyer, willing seller" standard.[4] While a taxpayer may prefer, in a particular instance, to pay the tax alleged to be due and timely file a claim for refund and then refund suit, the "full payment" rule—or problem—in this area makes the Tax Court an attractive litigation arena for taxpayers.[5]

There is a plethora of reported judicial decisions from the federal courts, including the United States Tax Court, on cases pertaining to the valuation of closely held business interests. The large volume of such cases reflects that one or both sides to the

dispute felt the matter was worth the cost and risks in fighting it out before the fact-finder. The case law, however represents only a small fraction of the unlimited number of valuation controversies and disputes, many if not most of which are settled at audit, at the appeals level, or before trial.

It is common that a taxpayer, under our self-assessment system of reporting liabilities for tax under the Internal Revenue Code (the "Code"), will report a value for a particular item on a return or other information or required filing in a manner that tends to reduce or minimize the potential liability involved. The taxpayer is not, absent special facts in the case, qualified to provide an expert opinion but can, as a taxpayer, provide testimony about what he or it believes may be the value of the business or the particular business interests to be valued, but only as a layperson.[6] The taxpayer will be required to provide a written report setting forth one or more opinions of value from an independent and qualified appraiser who can demonstrate that he or she has the sufficient professional credentials, experience, and knowledge to be accepted as an expert for submitting (non-scientific) business valuation testimony.[7]

Tax controversies and litigation on valuation issues between taxpayers and the Commissioner have frequently occurred at numerous times and in various contexts in which a valuation return position is required. Areas in which valuation cases occur more frequently involve:

- The valuation on contributions of property in claiming charitable deductions;[8]
- Transfer pricing "arm's-length values" determined in accordance with the regulations under section 482 and at times extending to applicable tax-treaty provisions;[9]
- The value of a transfer of property by gift, such as the gift of shares of closely held stock;[10]
- The estate tax value of property owned or deemed to be owned by the decedent's estate at death, including interests in privately owned businesses;
- The valuation of specific assets and the enterprise value ("unrealized built-in appreciation") of a corporation converting from a regular or C corporation to Subchapter S which thereby invokes application of the built-in gains tax under section 1374.[11]

These are just to name a few. Yet another of the countless examples that can be cited is the sale of property between related parties that is represented to be full and adequate consideration in money or money's worth under section 2043, sections 2036 through 2038, or in avoiding a potential transfer by gift with respect to the sale of property to a family member or business entity.[12]

The generally applicable standard in valuation cases under the Code is the "willing buyer, willing seller" standard. The question this standard asks is, "What is the price that the property being valued would be arrived at (in a hypothetical purchase and sale on the applicable valuation date) between a willing buyer and willing seller, neither being under any compulsion to purchase or to sell, and both having reasonable knowledge of the facts?"[13] Depending on the specific context of the case, a taxpayer may seek the lowest reasonable and well-reasoned opinion of value to use in reporting his or its tax obligation to the Service. In instances such as a charitable deduction under section 170, the taxpayer's motivation may be to obtain the highest value that is reasonable and well-reasoned.[14] For estate and gift tax purposes, when a taxpayer strays too far from the ultimate finding of fair market value, there are penalties set forth in the Code with respect to substantial or gross valuation misstatements, which focus on the extent that the asset being valued was understated.[15] There may also be instances in which the same penalty could be imposed on valuations, resulting in an erroneous overstatement of tax basis, such as under section 1014.[16] When excessive deductions associated with a charitable contribution are claimed by the taxpayer, a penalty will be imposed based on the extent that the overvaluation caused a significant underpayment in tax.[17]

The Tax Court has made it quite clear to both sides in a valuation dispute that it wants the parties themselves to arrive at an agreed settlement of the case without litigation. [18] Indeed, it is universally accepted that valuation is not a "precise science" and therefore if the parties to the dispute would simply negotiate a fair compromise, such would save the parties the additional cost, time, and uncertainty of outcome that is instrinsic to litigation of a valuation case. The risk, of course, is that the Court may not split the difference, and determine the fair market value which is the mean of the range of values presented on one hand by the petitioner and on the other by the respondent. The Court could side with one party more than the other, particularly when the valuations presented by one party lack the proper foundation, expert testimony, are based on facts that are not complete or are incorrect, the expert testifying or who submitted the report in question is more of an "advocate" than an independent professional, or suffers from a conflict of interest or bias. [19] A regularly cited observation of the Tax Court is sourced to its opinion in Buffalo Took & Die Manufacturing Co. v. Comm'r: [20]

> We are convinced that the valuation issue is capable of resolution by the parties themselves through an agreement which will reflect a compromise Solomon-like adjustment, thereby saving the expenditure of time, effort, and money by the parties and the Court—a process not likely to produce a better result. Indeed, each of the parties should keep in mind that, in the final analysis, the Court may find the evidence of valuation by one of the parties sufficiently more convincing than that of the other party, so that the final result will produce a significant financial defeat for one or the other, rather than a middle-of-the-road compromise which we suspect each of the parties expects the Court to reach. If the parties insist on our valuing any or all of the assets, we will. We do not intend to avoid our responsibilities but instead seek to administer to them more efficiently—a factor which has become increasingly important in light of the constantly expanding workload of the Court.[21]

When a settlement cannot be reached and litigation results, a valuation case will inevitably come down to which expert or experts most impress and persuade the court as the ultimate fact-finder of "fair market value." In this regard, as with expert testimony of a scientific nature, the parties will offer their valuation experts who, as will be discussed in Part 2, testify in producing their reports for trial, offer deposition testimony, and testimony at trial.

In general, the courts will admit opinion testimony of an expert if it will assist the trier of fact to understand evidence that will determine a fact in issue, such as the fair market value of a closely held business interest which is not readily tradeable.[22] Such opinion testimony is weighted by the trier of fact in light of the "demonstrated qualifications of the expert and all other evidence of value."[23] The Tax Court, and other trial courts in tax refund litigation, have been careful to note that the trial court may "embrace or reject expert testimony, whichever, in our best judgment, is appropriate."[24] It is therefore inevitable that in certain instances the court will reject expert testimony when the witness' opinion of value are exaggerated to such extent that such testimony lacks credibility.[25] When the Court finds either side's expert testimony is flawed or deserves little weight, the other side will undoubtedly prevail. When the government wins the case because of flawed or unpersuasive expert testimony, the imposition of accuracy-related penalty rules becomes more certain, subject to any allowable defense that the petitioner might be able bring to the Court's attention.

History of the United States Tax Court

Approximately 100 years ago, Congress created the Board of Tax Appeals as an administrative body to allow taxpayers to present their case to reduce the amount of a proposed tax liability determination by the Internal Revenue Service before being required to make payment of the "deficiency" in tax.[26] Congress did not find that payment in full be a condition before a taxpayer was provided with access to a court of review of what could ultimately prove to be an incorrect assessment of tax. [27] The Board of Tax

Appeals would therefore allow for a determination of the correct amount of the deficiency in tax with respect to taxes imposed under the Code, such as proposed deficiencies in income, gift, or estate tax, subject to special jurisdictional matters.[28] The term "deficiency" is the amount by which the tax imposed exceeds the amount shown by the return of the taxpayer after the return was increased by the amounts previously assessed or disallowed.

In 1942, 18 years after Congress established the Board of Tax Appeals, Congress renamed the court the Tax Court of the United States to confirm that the court was not an administrative body acting on behalf of the executive branch of the federal government.[29] In the Tax Reform Act of 1969, section 7441 was enacted, establishing the "United States Tax Court" as a court of record under Article I Section 8 of the U.S. Constitution.[30] In 1972, the Tax Court promulgated Rules of Practice and Procedure that were approved in 1974.

Deficiency litigation before the United States Tax Court

In general, the Tax Court is a forum for the resolution of a controversy as to a deficiency in federal tax before the assessment. The Tax Court's jurisdiction is actually much broader than just hearing deficiency cases, as it has been further granted by Congress the authority to determine overpayments in tax, render collection due process determinations, and also to render declaratory judgments.[31] Under section 6211(a)(1), a deficiency in tax is the excess of: (1) the sum of: (i) the amount shown as tax by the taxpayer on his return, if a return was made and amount shown as the tax by the taxpayer; plus (ii) the amounts previously assessed (or collected without assessment) as a deficiency, less: (2) the amount of "rebates" as defined in section 6211(b)(2).[32] When an amended return is filed showing tax owed for more than the amount shown on the original filed return, the additional amount is treated as the amount "shown upon [the] return." If no return is filed, the amount of tax "shown on the return" is zero.[33] Payment of the proposed assessment of tax by the taxpayer after the issuance by the Service of a notice of deficiency does not divest the Tax Court of jurisdiction.[34] In a deficiency case, as mentioned, the Tax Court has jurisdiction to redetermine the correct amount of the deficiency even if such amount is greater than the amount of the deficiency set forth in the 90-day letter.[35] An attempt by the Service to increase an income tax deficiency is timely whether presented during taking of evidence before the court or the period allowed for argument or briefs; i.e., at any time before the decision and judgment have been entered. On raising a new matter or demand for an increased deficiency, the government bears the burden of proof.[36]

On the other hand, the Tax Court also has the authority to determine that there was an overpayment in tax instead of a deficiency for the year involved and order a refund.[37] An overpayment determined by the Tax Court must be restricted to: (i) amounts paid after the notice of deficiency was sent; (ii) amounts where a claim for refund could have been filed on the date the deficiency notice was mailed, and (iii) amounts covered by timely refund claims that were pending when the notice was mailed. Therefore, in an estate tax valuation case, for example, if the taxpayer prevails on proving that the reported value was higher than the actual fair market value of the business interest (or other asset values) in question, it is possible for the court to find that the estate tax liability of the estate-petitioner was overpaid and that a refund in estate tax is due. There are a multitude of reported tax procedure cases that involve the Tax Court's limited jurisdiction to decide deficiencies in tax.[38]

In contrast to deficiency litigation in the Tax Court, where the taxpayer does not have to make payment of the proposed assessment in tax prior to a final determination of the Court,[39] a tax dispute may also be litigated before a United States District Court in the area where the taxpayer resides or before the United States Court of Federal Claims.[40] The problem with both other tribunals, though, is the "full payment rule" announced by the Supreme Court in Flora v. U.S.[41] The full payment rule is a jurisdictional requirement that the taxpayer, as a (second) condition precedent to filing a tax refund suit, must

pay the full amount of tax due. (The Supreme Court in Flora indicated that full payment did not extend to the payment of assessed interest and penalties, however.)[42] While there are certain limitations on the full payment rule provided by statute, the rule applies to income, estate, and gift taxes as well as federal excise taxes assessed under Chapters 41-44. There is no right to a jury trial in the Tax Court or the Court of Federal Claims, but either party may request a jury trial in a refund suit before a federal district court. With a refund suit, there is an added (first) jurisdictional requirement that the taxpayer, before timely filing a refund suit, had previously timely filed a claim for refund. Under section 6511(a), a claim for credit or refund of an overpayment in tax must be filed within three years from the time the return was filed or two years from the time the tax was paid, expires later, or if no return was filed by the taxpayer, within two years from the time the tax was paid. As to the filing of the refund suit, the law provides that such action cannot be brought until six months after the claim for refund has been filed with the Service unless the Service acts on it within those six months, in which event the suit cannot be brought immediately after the Service's decision is rendered.[43]

In a refund suit, the applicable court may only entertain, as "set forth in detail [by the taxpayer], each ground on which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof."[44] This principle, referred to as the "doctrine of variance," precludes a taxpayer from raising factual or legal grounds at trial (refund litigation) that are at variance from those stated in the refund claim. When a substantial variance exists and is timely objected to by the United States, the taxpayer's refund suit as to such particular ground or theory will be dismissed to the extent of the variance.[45] When the taxpayer succeeds in establishing an overpayment in tax for a particular year, the resulting refund in tax will accrue interest from the date the overpayment occurred through the date of payment at the statutory prescribed rate under section 6621.

Appeals from adverse decisions of the United States Tax Court and final judgments of a federal court may be filed in the time and manner provided[46] with the court of appeals where venue exists based on the taxpayer's place of residence or principal place of business.[47] For decisions of the Court of Federal Claims, appeals are taken to the Federal Circuit Court of Appeals.[48]

While there are various practical and legal issues to consider in a taxpayer's selection of the forum to have a valuation case tried, as with any other tax case, an important distinction among the available options is not only the full payment rule issue but that the judges of the United States Tax Court reflect a national, specialized bench of tax law and litigation experts.[49] The Tax Court is further interested in setting national standards for the proper interpretation and application of the Code. This interest or judicial policy toward horizontal equity is sometimes interrupted when the circuit court's precedent on the particular subject is, as a practical matter, binding on the Court. As to valuation, the Court's case load always reflects relatively high percentage valuation-related matters.

Another factor pertaining to selection of the forum for a valuation case is whether a jury trial is preferable. A jury may be requested by either party in a tax refund suit in federal district court. The members are unlikely to have the knowledge, familiarity, or experience necessary to fully and carefully deliberate a valuation case. Perhaps that is a bit harsh, but it must be borne in mind by tax counsel, particularly when the government's valuation position seems to be overly inflated or aggressive. The jury might identify with the government's position in general and the extent of such "leaning" towards the government's argument further depends on the particular facts of the case, the credibility of the witnesses (including expert witnesses), and other factors. The jury might not readily identify with a high net-worth taxpayer or large estate. Obviously, the judge will have to consider the detail required to be set forth in a set of jury instructions.[50] Even if the jury's determination of value is essentially correct, there is always a risk that it can be skewed too high

upward if the government's valuation position can be characterized as "aggressive" or "at the high end of the value spectrum." Tax counsel should always keep this in mind before filing a tax refund suit in federal district court.

In large, highly technical cases, including valuation cases, therefore, many taxpayers have opted for a non-jury forum before the Court of Federal Claims where neither party may request a jury trial. Federal trial judges presumably have much experience in hearing cases concerning valuation matters such as damage suits for lost profits, lost business opportunity, fairness opinions, dissenters' rights actions, and the like. While a particular federal jurist may not have a detailed understanding of federal tax law, it is most unlikely that the concept of "fair market value" will be new to the judge appointed to hear the case. Also, the taxpayer might be leery of a non-jury proceeding, believing that the tribunal will be disposed toward the overly technical aspects of the case and be inclined to favor the government's position. On the flip side, another choice of forum factor is that the trial judge in the Court of Federal Claims or federal district court may not be familiar with specific parts of the Internal Revenue Code at issue or may indeed lack an overall knowledge of federal income or transfer tax. The Court of Federal Claims, as with the United States Tax Court, is a court of national jurisdiction. Both courts will consider a forum conveniens for the taxpayer or will entertain that the place of trial be held with the Court's main location in Washington, D.C.[51]

As mentioned, a valuation issue that generates a proposed deficiency in tax can arise within the context of a limitless number of provisions contained in the Code. This would include, for example, the value of an in-kind charitable contribution of property under section 170,[52] the valuation of stock options or restricted stock under section 83, and the value of closely held stock or interests in a partnership or limited liability company for gift tax purposes under section 2511, estate tax purposes under section 2031, or generation-skipping transfer tax under section 2601.[53] For the Tax Court to acquire jurisdiction in a tax dispute, there needs to be a "deficiency," as such term is defined in section 6211(a), in tax be it in income, estate, or gift tax.[54] Before assessment and collection of deficiencies in tax can be made, sections 6212 and 6213 require the Service to first issue (i) notice (the so-called 90-day letter) of deficiency, and (ii) a 90-day period (150 days for taxpayers outside the U.S.) for the filing a petition in the Tax Court for redetermination. No assessment or collection of the deficiency can be undertaken by the Service until the expiration of the period for filing a petition in the Tax Court, or, if the taxpayer timely files a petition, until the decision of the Tax Court becomes final.[55]

General rules for valuation of closely held business interests in corporations and partnerships

The valuation of ownership interests in a corporation or partnership, which interests are not publicly traded, has long been the subject of many Tax Court decisions as well as decisions of the federal district courts and Court of Federal claims in tax refund suits. The Tax Court has observed on various occasions that "the valuation of property is an inexact science, and, if not settled by the parties, must be resolved by the judiciary by way of 'Solomon-like' pronouncements." [56]

While there are many instances in which the valuation of business interests is required for income tax purposes, stock and partnership interest valuation questions have generated many tax controversies, including trials involving the Commissioner of the Internal Revenue Service and the taxpayer, be it the settlor of an irrevocable trust, the donor of a completed gift, or the estate of a decedent owning, directly or indirectly at death, such ownership interests. The long-standing principle for defining "fair market value" (and not simply the "fair value" of closely held stock)[57] is "the price at which the property would change hands between a willing buyer and a willing seller; neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[58]

The courts have adopted various methods for valuing ownership interests in privately owned corporations or partnerships under the willing buyer, willing seller standard. The sale transaction is a hypothetical transaction that does not represent a forced sale by an otherwise unwilling seller. It would not involve a "quick sale" by an impulsive seller as well. [59] Hindsight is generally not factored into the equation, only those market conditions and facts known on the valuation date.[60]

With respect to the estate (and gift) tax value of closely held stock, Rev. Rul. 59-60[61] sets forth the government's view of the various methods and factors to be considered in valuing shares of capital stock of a closely held corporation for estate and gift tax purposes, where there is no established market for the stock and sales of such stock occur at irregular and perhaps unforeseeable intervals. The pronouncement recognizes that an appraiser will find "wide differences of opinion as to the fair market value of a particular stock." Therefore, the Ruling states, "in resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance."[62]

When market quotations are unavailable or too scarce to be recognized for closely held stock, all available data must be examined, as well as the eight "intrinsic" factors set forth in Rev. Rul. 59-60. These are: (i) the nature of the business and the history of the enterprise from its inception; (ii) the economic outlook in general and the condition and outlook of the specific industry in particular; (iii) the book value of the stock and the financial condition of the business; (iv) the earning capacity of the company; (v) the dividend-paying capacity of the corporation (and actual dividend payment history reflected in case (vi) the presence or absence of goodwill, or other intangible value; (vii) sales of stock and size of block of stock to be valued; and (viii) market price of stock of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over the counter.

Rev. Rul. 59-60 acknowledges that in each particular case the weight given to any of the enumerated factors can vary, as will the capitalization rates to be used under an income or projected cash flows model. The various valuation factors have to further take into account the effect of restrictive agreements, the degree of thin management, or factor for key employees and whether such key employees are under contract. There are other factors that potentially must be taken into account in a valuation case besides the lack of a public market for the shares or recent arms-length sales that are close in time before or after the valuation date. Such added factors include whether a "blockage" discount is reflected in the shares being valued, whether the shares should be valued with an added control premium,[63] and reducing or discounting the value of a minority ownership interest as well as an interest that is non-voting.[64]

There are various valuation methods or models that have gained currency both with valuation experts and the courts. These methods have been admitted into evidence through an appraisal submitted with the return or through expert opinion for courts to evaluate in rendering decisions on the fair market value of a business interest. In many cases, the appraiser or expert witness will not simply rely on a single method or model but may find it is more supportable to apply different models and then address how much weight should be given to each model in arriving at a fair market value—a "weighted average" determination. Among the various equity valuation models are the book value or asset value approach, the capitalized earnings method, earnings method, the dividend approach, and the market or comparable sales method.[65] A brief summary of the most frequently used models follows. The case law reflects that the courts will evaluate the percentage or weight given to each model or perhaps even discard one model or several if it rejects the underlying premise for its use. [66]

The book or cost value of all assets of the business is a valuation factor but its use as a model to value shares of stock in a corporation or interest in a partnership may be of negligible importance unless it takes into account actual appreciation or depreciation in setting for the value of the assets or the earnings capacity of the company. Certain assets, such as real estate owned by the business, may require separate valuations as well under different standards. Moreover, "book value," per se, does not reflect the value of intangible assets including trademarks, tradenames, copyrights, business know-how, customer and supplier lists, going concern value, or goodwill. When book value is adjusted to account for the fair market value of the assets on the balance sheet, then as an asset value method, the method should be of some significance, particularly with asset-based companies such as commercial real estate or development businesses. [67]

The earnings approach projects the corporation's future earnings in order to determine the corporation's (or partnership's) current fair market value. The information used to project the company's future earnings capacity must be based upon the corporation's current financial status with the expectation that the company will continue to maintain operations into the future over a selected period of years. Future earnings are projected and discounted to a present value at a discount rate that should reflect the cap or discount rate that a willing buyer would expect to receive in return.[68] There would also be an expected residual value to the business.[69]

The capitalization of earnings method is the conversion of expected earnings into a present value. It attempts to value what a willing buyer will pay for the stream of profits expected into the future with prior years' earnings assumed to be reliable indicators of future earnings. Then average prior years' earnings are capitalized. The ratio of the capitalized price to the average earnings is the "multiplier." In some instances the expected rate of return on tangible assets is computed with the "excess earnings" going into the calculation of the capitalized earnings on intangibles.[70] One problem, of course, is selecting the proper rate of return as well as the capitalization rate. The capitalization rate can be extracted from looking at the price/earnings ratios of comparable public companies. The next problem is finding "good" comparables.[71]

The market or comparable company method approach determines the value of a closely held corporation (or partnership) based on analyzing financial data, including price/earnings and ratios, of public corporations in the same or substantially similar line or lines of business.[72] There are factors used in a comparability model that have been acknowledged by the courts in valuation cases involving closely held stock. Among such factors are:

- The identity and similarity of the markets or industry sections in which the companies engage in business operations;
- Degree of depth in management and structure of the comparable companies;
- Size and success of the comparables within the industry and compared with the target corporation's size and standing as a privately owned business;
- Earnings before interest and taxes and possibly debt service;
- The product fields or lines of businesses conducted by the comparable companies; and
- Other factors.

Adjustments in this hypothetical comparative price are then made as justified by the differences that do exist between the unlisted company and the listed comparables.[73]

An important factor or criteria in Rev. Rul. 59-60 is a corporation's dividend capacity. In many instances an appraiser or expert valuation witness will review and take into account the corporation's actual dividend payments over a three- to five-year (or more) period and not just its dividend paying capacity. Evaluating actual dividend payments made would invite a comparison based on the capitalization factor based on the dividend yields presumably reflected in SEC filings made by comparable public companies compared with the company whose

shares of stock are the subject of the valuation. In certain instances, the capacity to make distributions may prove to be a more appropriate factor, particularly when the percentage of stock ownership being valued is significant or substantial. This would occur when an estate holds a 40 percent stock interest in a closely held corporation and the decedent was a highly compensated employee. The company did not make significant dividend distributions to avoid double taxation. Therefore, in such situations, the actual dividend paying history may not be as important a measure or factor in the valuation mix. But, however, when a minority interest is being valued and the owner of the interest does not work in the business as a key employee, actual dividend history as well as rights to receive distributions set forth in the governing instruments of the stock and of the company are both important considerations that a "willing buyer" must consider.[74]

When a corporation has more than one class of stock outstanding, applying the stock valuation methods discussed above becomes more complicated. In Rev. Rul. 83-120,[75] the Service, in amplifying Rev. Rul. 59-60, set forth significant factors to be used in determining the fair market value of preferred and common stock received in certain corporate reorganizations, including preferred stock recapitalizations under section 368(a)(1)(E). It noted that the typical family corporation recapitalization involves the senior family member or generation exchanging common shares for preferred stock which then absorbs most of the underlying earnings value of the company. The gifts of common stock to the next generation(s) would therefore come at a low gift-tax cost.[76]

The government set forth several factors in valuing the preferred stock issue in this context. The most important factors being the yield on preferred shares, dividend coverage, and liquidation preference. The first factor of yield on preferred stock that will support its par value depends on the adequacy of the dividend rate, which "should be determined" by comparing its dividend rate with the dividend rate of high-grade preferred stock. A lower yield may reflect that the value of the preferred is less than par, thereby increasing the residual value to be allocated to the common shares. A higher dividend rate causes more value to be allocated among the preferred stock class and less value to what is left of the enterprise value, i.e., to the common shares.[77] Next is the actual dividend rate and whether it will be the stated rate set forth in the instrument. There is the risk, therefore, that the corporation will not be able to meet its obligation to pay the stated rate or perhaps the stated rate will be cumulative and then, if cumulative and left unpaid, whether the arrearages will be paid and when. Alternatively, if the dividend term is non-cumulative, that would tend to shift value to the residual portion or common shares. When looking at the actual dividend rate, Rev. Rul. 83-120 provides that the corporation's prior earnings history is important.

There also is the liquidation preference feature measured by the ratio of the excess of the current market value of the corporation's assets over its liabilities that would fund the aggregate liquidation preference of the preferred. This so-called "protection ratio" should be compared with high-quality publicly traded shares. Other factors are voting rights, as well as put rights or call rights.[78]

The underlying value not attributable to the preferred shares is the "residual" amount allocated to the common shares. This is referred to as the "subtraction method" of valuation. While there is some logic behind Rev. Rul. 83-120, there is also the problem that it may not fall within the strict confines of the willing buyer, willing seller standard. The Tax Court in Estate of Newhouse v. Comm'r,[79] rejected the respondent-Commissioner's use of the subtraction method through its expert valuation witnesses. The decedent, Samuel I. Newhouse, owned all of the outstanding shares of Class A voting and Class B nonvoting common stock in a closely held corporation, Advance Corp., the value of which was includible in his gross estate under section 2033. Other family members owned all of the outstanding shares of the company's preferred stock. The corporate charter of Advance provided that the voting common stock had exclusive rights to elect the Board of Directors, that all three classes of stock participated pro rata

in dividends declared out of earnings, that the preferred stock had a liquidation preference, and that only the common stock could vote on plans for merger. The preferred stock was authorized by statute to vote on corporate liquidation. In a proposed deficiency in estate tax of $609.5 million plus a civil fraud penalty of $304.8 million, which penalty the government would concede, the Tax Court had to determine the value of the decedent's shares in two classes (voting and non-voting) in Advance Publications, Inc. as well as the value of common stock in Newhouse Broadcasting.

Both parties presented expert witnesses to testify on the proper valuation (and methods) to be viewed in valuing the shares of stock at issue. The government's approach was that the value of the common shares should be determined for common stock based on the decedent's ability to eliminate the preferred stock (in Advance Corp). The Tax Court, per Judge Williams, found this approach "astonishing" and stated that "noted legal experts have given contrary opinions in this case." The Court was skeptical that a willing buyer of the common stock in the corporation would ever determine the price to be paid for such shares by applying the subtraction method. On this point, Judge Williams, writing on behalf of the Court opined:

> Not only is there no support in the record for the subtraction method in this case, but we conclude that it is far too simplistic a method for the valuation of the Advance common stock. An underlying fallacy in this theory of valuation is the assumption that the sum of the fair market values of the preferred stock and the common stock, each sold independently to separate buyers, must equal the net value of the entire company as a going concern. Massive amounts of credible evidence in this case indicate that this assumption is not supportable. If all the common and preferred stock in the company were sold at one time to a single buyer, we have little doubt that the price would approach the values that the experts on both sides determined for the business as a whole. But if either class of stock is sold separately, a buyer cannot be reasonably certain of his ability to eliminate or control the other shareholders, and the price will be less than its proportionate share of the total value. Although the subtraction method may be suitable for other situations, its use is inappropriate for Advance. 94 TC at 247.[80]

The Court proceeded to rule based on the methods used by the petitioner's experts:

- Comparable company valuation;
- Initial public offering value;
- Potential merger value;
- Sum of the values of assets if sold in independent transactions; and
- Discounted cash flow analysis.

The Tax Court concluded that the public offering approach was the most logical approach open to a willing buyer under the facts and determined a value of $176 million for the common stock. The use of the subtraction method by the Service provided a value (net of the value of the preferred stock) of $1.23 billion. Yes, more than a billion dollars greater than the Court's determination of value!

The subtraction method of valuation was adopted by Congress in enacting section 2701 of the Code.[81] Treas. Reg. §20.2701-3 sets forth the applicable rules for applying the subtraction method of valuation in a section 2701 gift tax setting.[82]

> (a) Overview—(1) In general. The amount of the gift resulting from any transfer to which section 2701 applies is determined by a subtraction method of valuation. Under this method, the amount of the transfer is determined by subtracting the values of all family-held senior equity interests from the fair market value of all family-held interests in the entity determined immediately before the transfer. The values of the senior equity interests held by the transferor and applicable family members generally are determined under section 2701. In general, section 2701 applies where a family member gifts an equity interest in a privately owned

corporation or partnership for the benefit of a lineal descendent and/or members of his family where immediately after the transfer the transferor or ancestor owns an applicable retained interest in the same entity or affiliate where the retained interest includes an "extraordinary payment right" or a "distribution right" as such terms are defined.[83] Other family-held senior equity interests are valued at their fair market value. The balance is then appropriately allocated among the transferred interests and other family-held subordinate equity interests. Finally, certain discounts and other appropriate reductions are provided, but only to the extent permitted by this section.

Section 2701 was adopted by Congress in response to the Dean-Hartzell preferred stock recapitalization strategy used to shift future appreciation to the younger generation shareholders or members of a family business or investment entity which the senior generation retain a priority to cash flow, liquidation proceeds, control, and other rights.[84] Such recapitalizations typically created a class of preferred stock representing nearly the entire value of the corporation and one or more classes of common stock that could then be gifted away at a minimal tax cost.

Section 2701 provides, in general, that when applicable retained interests are held by senior family members, the subtraction method is used to value the resulting transfer of common to junior family members. In certain instances, the value of the retained interests are ignored under the statutory rules which rights would not be ignored in valuing the preferred stock or preferred interests under general valuation principles. Unless section 2701 or related provisions contained in the Chapter 14 quartet are involved, the general valuation methodologies determined under case law, including Judge Williams' criticism in Estate of Newhouse that the subtraction or residual method of valuation is not appropriate to apply when the valuation is with respect to a separate ownership interest in a closely held corporation will be applied by a court in a valuation case. Indeed, the hypothetical sale under the Regulations to section 2031 do not call for the hypothetical sale to be the sale of the entire enterprise in a single transaction.

Presence of discounts from normative per share/ unit value in determining fair market value

A minority ownership discount is nearly universally accepted in valuing an ownership interest in a closely held business entity. Perhaps the government may not concede that point when there is a concentration of ownership in one or perhaps two families who have operated the business for years, even if the ownership tests under sections 2701 or 2704 are not satisfied.[85] Even under a net asset value approach, it may be appropriate to decrease value to reflect the owner's lack of control with respect to his ownership interest.[86] This is based on the fact that a minority shareholder may not be able to realize the value of his pro rata share of the earnings or assets of the business entity through the receipt of dividends or distributions, compensation, or other benefits.[87] There may in fact be a "majority" owner or group which could exacerbate the degree of the applicable discount. In determining whether a minority interest is present under the facts, the government's efforts to combine ownership held by attribution of other family members has been unsuccessful.[88] In some instances the courts may view a minority ownership interest as part of the discount for lack of marketability but there is a clear distinction between the two.[89] A willing buyer, therefore, would pay less per share of stock or interest in a partnership, when the interest purchased does not have a meaningful voice or control over organizational governance, operations, dividend or distribution policy and change of control or acquisition or divestiture decisions.

As a "contra-discount," when an ownership interest in stock or in a partnership constitutes actual voting control of the corporation or partnership, such interest's value is increased by the control such ownership interest, may have on the control on the entity. As stated in Rev. Rul. 59-60:

> The size of the block of stock itself is a relevant factor to be considered. Although it is true that a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock.

This control takes into account the areas of corporate governance, operations, voting, distributions, change of control transactions, acquisitions, etc. While the regulations may not clearly make the point that "actual control" is required, the case law places an emphasis on the presence of "actual control."[90] Where such a "control premium" is present, it is added to a normative value used as the base per share or unit value.[91] The particular weight to be given to such factors is based on all facts and circumstances taking into account the fiduciary duties under state law owed by a majority shareholder(s) to minority shareholders.[92] The cases that have addressed this issue reflect that each case stands on its own facts, which makes it difficult to predict whether a court will agree that a control premium exists and then what that value increase per share/unit will be.[93] The control premium is added to normative (minority based) share value.[94] In Estate of Simplot v. Comm'r,[95] the decedent owned a 23.55 percent minority voting share block in a privately owned corporation. There were two classes of stock voting and non-voting common. The decedent owned 18 voting shares and his three siblings held the remaining voting shares in blocks from 23.55 percent to 29.35 percent. In determining the value of the estate's 23.55 percent minority voting shares, the Tax Court thought it was foreseeable that one day, but after the valuation date, the voting characteristics could have a "swing vote" potential where the hypothetical buyer would combine his (hypothetical) purchase of 18 voting common shares with one or more of the other voting shareholders in an effort to form a controlled group. The Tax Court, somewhat amazingly, at least to this author, added a premium of three percent *of the entire enterprise value* in proportion to the decedent's percentage of voting stock to all voting stock owners. Granted there was found to be a 35 percent lack of marketability discount for the voting shares owned by the decedent (emphasis in italics added). The court's analysis and holding on this swing vote premium seemed somewhat odd based on the willing buyer, willing seller standard under the applicable regulations, but perhaps more importantly, the decision by the full panel of the Tax Court could raise far-reaching ranges of value for minority holders of both voting common as well as voting and non-voting common. The idea that this premium would be based on enterprise value even though the decedent only owned 23.55 percent minority voting share block made the Court's valuation conclusion almost surreal.

Fortunately, the petitioner-estate appealed to the Ninth Circuit which then reversed the Tax Court on several grounds.[96] Most importantly, it found that the Tax Court's add-on of a three percent of enterprise value was based on an imaginary scenario involving a potential buyer purchasing not only the decedent's stock but that of another holder of voting stock which strayed well beyond the hypothetical willing buyer, willing seller. The applicable legal standard is based on a single purchaser who is only willing to purchase the decedent's stock as of the applicable valuation date and not some possible date in the future. It further found it was reversible error for the Tax Court to calculate a premium for all of the voting shares as a block and then divide that premium by the number of voting shares. The Ninth Circuit opined that there was no basis for the Tax Court to assume that the premium value, even if it was proper to conclude it was present, attached to all of the voting shares on a pro rata basis. In order to find that a premium existed, the trial court was engaged in valuing all of the voting common, not just the decedent's voting stock. The appellate court further found reversible error by the trial court's valuing the decedent's minority interest in the voting shares at a premium, because the government did not prove that there was in fact an economic premium associated with the willing buyer's purchase of the decedent's voting shares.

In addition to the minority interest discount, stock of a closely held corporation, as well as interests in a partnership or limited liability company, that are not registered on an exchange or with respect to which there is no readily available market for sale, can be discounted from normative value. The amount of the lack of marketability discount depending on the facts of the case can be substantial.[97] In certain instances, the presence of a restrictive shareholders agreement may affect the amount of the discount. For example, in Estate of Lauder v. Comm'r, the Tax Court allowed a 40 percent lack of marketability discount with respect to decedent's ownership in closely held stock where the estate could not sell its stock without first offering the stock to the corporation or to the remaining shareholders. This is a common practice with closely held business entities, particularly those owned by one or more families who wish to retain the ownership of the company in the family. The Tax Court had previously held,[98] that the right of first refusal formula was primarily intended to serve as a device to avoid estate tax or stated different, to pass on the Este Lauder company stock to family members for less than full and adequate consideration.[99] In the later proceeding, the Court granted the government's motion in limine to preclude the presence of the shareholders agreement into evidence. The Tax Court held that the specific provisions of the shareholders agreement are not relevant to the question of the fair market value of the decedent's stock on the valuation date.

What is more common of course is that the discount for lack of marketability for unlisted stock sales of similar interests in like companies are considered such as the average marketability discount for a public corporation's transfer of restricted stock as well as the average discount for an initial public offering including costs associated with making a public offering. Special consideration is given to the financial statements of the company such as capitalization, income statement, footnoted materials, contingent liabilities, reserves, future earning power, quality of earnings and goodwill, to name a few. Then the company's dividend policy and dividend history is taken into account. Also considered is the nature of the company, its history, position in the industry and economic outlook, the company's management, and amount of control, if any, in the transferred shares. Other factors may also be relevant in arriving at the lack of marketability discount, including the absorption rate for the sale of a block of stock or the prospect of a substantial corporate-level tax that may be incurred as a result of being acquired perhaps through a taxable merger or section 338(h)(10) or section 336(e) type transaction.[100]

A potential discount that may be claimed from net asset value or under an income method is the potential reduction in value associated with taking into account the corporate income tax imposed on regular or C corporations or alternatively for S corporations, which may be subject to the built-in gains tax under section 1374 after converting from C to S status particularly when the applicable valuation date is within the "recognition period" defined in section 1374(d)(7). This discount from enterprise value came into view after the Tax Reform Act (TRA) of 1986[101] which repealed the former "liquidation bias" present under the corporate income tax provisions under former sections 337 and alternatively, section 333, in avoiding part if not all of the corporate level tax on the sale of substantially all of the assets of the C corporation and complete liquidation. After TRA 1986, the liquidation bias was removed and C corporations are taxed on sales of assets or deemed sales of assets in what some may have viewed as preserving the non-integrated system of double taxation under Subchapter C.[102] As to the built-in gains tax under section 1374 which was enacted as part of TRA 1986 and has been revised several times sincee, a corporation converting to Subchapter S status would continue to be taxed as a corporation for a 10-year period (now five) with respect to its "net recognized built-in gains" realized during the recognition period but only to the extent of the unrealized appreciation of the corporation's assets which it owned as of the effective date of the conversion. This change in the law was referred to as the "repeal of the General Utilities doctrine," which got its name from a landmark decision of the Supreme Court in 1935.[103] The General Utilities doctrine allowed, in many, but not all, instances a corporation to avoid

federal corporate income tax in a corporate liquidation again under section 337 or a so-called one month liquidation under section 333 which had its own special set of rules.

Discount for corporate level taxes

Before TRA 1986, a court in review of a valuation controversy involving stock in a regular or C corporation, or perhaps even stock of S corporation that may have been subject to a more limited capital gains tax in certain instances, would not grant a discount for corporate-level taxes unless there was an impending sale of substantially all of the assets and/or complete liquidation of the corporation that would result in substantial corporate level taxes. The idea for not permitting the corporate-level tax discount was that the change of control even was too speculative in nature.[104] With the passage of the TRA 1986, the argument could be made with greater certainty that a willing buyer would take into account, in purchasing the stock of a closely held corporation, the built-in corporate income tax that it would economically bare to the extent of the percentage of stock being purchased. Therefore, if a C corporation had an average EBIT of $10 million (normalized to remove extraordinary income and expenditures) over the past three-year period and the capitalization rate were determined to be 10 percent, the enterprise value would be $100 million, without taking other factors into account. Assume further that there is no purchased goodwill on the company's balance sheet and that all other assets have a net book value of $0 which of course is an unreasonable assumption but used here for convenience. Therefore, there is a built-in gain tax on the sale of "goodwill" and similar section 197 intangibles on $100 million of unrealized appreciation if the corporation were sold for cash. The federal income tax on such gain would be 21 percent of $100 million or $21 million. Prior to 2018 it would be $35 million. Would a willing buyer purchase all of the stock of the corporation without taking the corporate-level tax it may later have to pay on a sale of corporation? The earnings model does not take corporate-level taxes into account. Why not? A willing buyer of the stock of a C corporation or S corporation presently subject to section 1374 would most likely want a discount from enterprise value for this tax. The same can be said for other assets of the corporation when the actual values far exceed the adjusted tax bases especially after taking depreciation into account. Such discounting of value in determining the purchase price that the willing buyer would pay, absent some favorable tax attributes that it may have already in place, would seem to be appropriate to take into account.[105]

The Second Circuit Court of Appeals in Eisenberg v. Comm'r,[106] was asked to review a gift tax case for the appellants' gifts of stock in a closely held corporation for three years (1991-1993) to her son and two grandchildren. The appellant reported the gifts with a discount by the full amount of the capital gains tax she would have incurred had the corporation liquidated, sold, or distributed the corporation's sole asset, a commercial rental property in Brooklyn, New York.[107] The capital gains discount was claimed on each year's reported taxable gift of stock. The government proposed deficiencies in gift tax based on denial of the potential capital gains tax liabilities.

The government's argument that a liquidation of the corporation or distribution of the appreciated building was not foreseeable and therefore the discount was speculative and uncertain. The taxpayer petitioned the Tax Court, which agreed with the Service.[108] The Tax Court also found there was no showing that a hypothetical buyer would purchase the Corporation with a view toward liquidating the Corporation or selling its asset, such that the potential tax liability would be considered a material or significant concern.

The taxpayer appealed to the Second Circuit Court of Appeals which, in light of the repeal of the General Utilities doctrine, stated that it is "[a] virtual certainty that capital gains tax will ultimately be realized in this case due to the changes brought about by the Tax Reform Act of 1986 taking into account the built-in gains tax under section 1374 even though the record did not reflect an intent that Eisenberg considered converting the corporation from a regular or C corporation to an S corporation." The

Second Circuit framed the issue not as to whether a liquidation was imminent or that a hypothetical willing buyer would purchase the stock and liquidate the corporation or sell its assets under the "too speculative to discount" approach. Instead of the issue being what the buyer intends to do with the property, the emphasis should be on the considerations the buyer would take into account in buying the property being gifted. Before General Utilities repeal, the buyer could avoid potential built-in capital gains tax. In contrast, after the TRA 1986 it considered it to be indisputable that the hypothetical willing buyer would pay less for the shares of stock because of the buyer's inability to eliminate the contingent tax liability. In addition, it noted a recent gift tax decision of the Tax Court, Estate of Davis v. Comm'r,[109] where experts for the taxpayer and the Commissioner as to the value of a minority interest in a closely held corporation agreed that a discount for corporate tax with respect to unrealized appreciation in the corporation's assets should be taken be taken into account.[110] The decedent had gifted shares of stock to his sons in his wholly owned corporation, the Winn-Dixie food chain operation. In using the net asset value method, the Tax Court agreed that a discount for corporate income tax was appropriate even if a sale of assets was not imminent but for a lesser amount than the 100 percent of the tax that would be owed on an immediate sale of the corporation's assets as the petitioner in Estate of Davis had argued. Aware that the change in the corporate tax law would be taken into account by a willing buyer and that such view had been taken into account by the Tax Court in a decision rendered one year after its decision in the case under review, the Second Circuit vacated the Tax Court's decision denying the corporate tax discount and remanded the case to the Tax Court to determine the gift tax liability of the appellant consistent with its holding that a built-in capital gains tax discount was appropriate. After Estate of Eisenberg, the corporate tax discount, frequently referred to as the "capital gains discount," was not whether the discount was too speculative to be allowed, but what amount of the discount should be allowed and should the discount identified be a separate discount or reflected as part of a lack of marketability discount.[111]

In Estate of Jelke v. Comm'r,[112] the Eleventh Circuit Court of Appeals held, consistent with the Second Circuit's view in Eisenberg v. Comm'r, that the valuation of 6.44 percent of the stock in a closely held investment holding C corporation which owned appreciated, marketable securities, would take into account a dollar-for-dollar reduction of the company's entire built-in capital gains tax liability at date of death on the assumption that the company was liquidated and all assets sold. The Tax Court below agreed with the Commissioner's expert witness testimony and allowed only a partial discount for the built-in gains tax liability, using projections as to when the corporation's real estate holdings would likely be sold which it determined would be over a 16-year period.[113] The Eleventh Circuit, in a case of first impression, engaged in a thorough review of the case law. It noted, in particular, the rationale and holding of the Fifth Circuit in Estate of Dunn v. Comm'r,[114] which granted a capital gains discount of the full corporate level tax of 34 percent that the corporation would have had to pay when and if its assets were sold under the net asset value method of valuation. However, the Court in Estate of Dunn, gave a weight of 15 percent to the net asset value method with a 34 percent corporate tax discount, while it allocated 85 percent to the earnings method of valuation which does not take any corporate income tax income account. The Eleventh Circuit opted for the dollar-for-dollar approach adopted by the Fifth Circuit over the present value tax cost model used by the Tax Court in Estate of Davis. The dollar-for-dollar approach offered certainty of treatment in contrast to determining, after taking evaluating expert testimony on both sides into account, as to the period of time when the corporation would reasonably incur the tax. That approach the court found to be "unpersuasive." The Eleventh Circuit determined that the date of valuation standard was more supportable based on the willing buyer, willing seller hypothetical purchase and sale on the specific valuation date:

> We are dealing with hypothetical, not strategic, willing buyers and willing sellers. As a threshold assumption, we are to proceed under the arbitrary assumption that a liquidation takes place

> on the date of death. Assets and liabilities are deemed frozen in value on the date of death and a "snap shot" of value taken. Whether or not a majority or a minority interest is present is of no moment in an assumption of liquidation setting.[115]

It has also been argued by taxpayers that discounts for corporate level taxes may also be appropriate in valuing shares of stock in an S corporation which is not subject to corporate income taxes. Nevertheless, many S corporations are forced, in effect, to make timely distributions of cash funds to its shareholders in order for them to timely remit estimated income and annual income tax payments on their distributed shares of the net taxable income and gains of the corporation. Under present law the maximum federal corporate income tax rate is 21 percent (although for many years it had been 34-35 percent) and the maximum federal individual income rate is 37.8 percent. Subchapter S affords the avoidance of income taxation on a dividend to the extent of taxable income previously passed through to the shareholders in accordance with sections 1366 through 1368. The presence of the qualified business income deduction under section 199A may also play a role in tax-affecting an earnings stream with respect to the trades or businesses of an S corporation at least while section 199A applies, after taking into account any applicable limitation and for as long as it remains on the "books."[116] The new tax law enacted in 2017 in reducing the corporate level tax, substantially reduced the double tax effect on dividends, since the qualified dividend rule in section 1(h) reduces earnings and profits dividend distributions to the same rate of tax as long-term capital gains. What this means is that with changes in corporate and individual income tax rates, the willing buyer will be re-calibrating the discount to be taken into account in purchasing shares of stock in a C corporation as well as an S corporation.

Given the attractiveness of closely held corporations to elect Subchapter S or migrate from a C corporation by converting to Subchapter S after the Tax Reform Act of 1986, should the impact of federal income taxes still be taken into account in valuing the shares of S stock? This would be taken into account by tax-affecting the net income of an S corporation when using an income method of valuation. The pressure to pay tax dividends to shareholders may also affect the discount rates used in comparing net-after-tax income models under the comparable public company method.

This tax-affecting argument for valuing S stock in a gift was rejected by the Tax Court in Estate of Gross v. Comm'r.[117] Despite receiving expert testimony that the Uniform Standards of Professional Practice (USPAP) required the earnings of an S corporation to be "tax-affected" the Court, per Judge Halpern, rejected the taxpayer's argument somewhat summarily on the basis that shareholders who want to elect Subchapter S do so in order to save federal (and state) income tax to avoid the non-integrated double tax system that is Subchapter C. The Sixth Circuit Court of Appeals affirmed Judge Halpern's Memorandum Opinion by a majority decision of the three-judge panel finding the lower court's decision on not permitting "tax-affecting" was not clearly erroneous.[118]

The Tax Court was again presented with deciding whether S corporation earnings should be tax-affected for estate tax valuation purposes in Estate of Adams v. Comm'r.[119] In Estate of Adams, the decedent owned 61.59 percent of a closely held S corporation. Both petitioner's and respondent's experts relied upon an income based model. The Commissioner's expert used the discounted cash flow method while the estate's expert relied on the capitalization of earnings method. The taxpayer's value was approximately one-half of the government's determined value. This was largely attributable to the petitioner's expert's use of a capitalization rate that was derived on a net earnings or income determinate on an "after-tax" or tax-affected basis. The Court did not agree and viewed its decision in the Estate of Gross as requiring a zero percent tax rate for determining the "after-tax base" for the capitalization rate on the notion that an S corporation's cash flows are subject to zero percent corporate tax.[120]

While there was a string of Tax Court decisions and other courts rejecting the tax-affecting of shares of stock in an S corporation which was not subject to corporate income tax,[121] a recent memorandum decision of the Court in Estate of Jones v. Comm'r may be viewed metaphorically as an "ice-breaker" naval vessel opening up a passageway in the Arctic circle to permit the income method to including tax-affecting in valuing shares of stock in an S corporation and possibly, on the same rationale that a tax on passthrough income is indirectly a charge on earnings, with respect to a partner's ownership interest in a partnership engaged in a large timber operation in Oregon.[122] At issue in Estate of Jones was the gift tax value of limited partnership interests in a partnership as well as minority blocks of stock in an S corporation which was the sole general partner of the partnership. The taxpayer's valuation expert tax-affected discounted the two companies income while, at the same time, found a premium present in valuing the companies to take into account that the entities themselves were not subject to income tax and could further make, to the extent allowable, non-taxable distributions to their partners or S shareholders.[123] The government challenged the tax-affecting income model based on several Tax Court decisions such as Estate of Gross and Estate of Giustina v. Comm'r. Judge Pugh, who issued the Memorandum decision for the Court, stated that he was more persuaded by the testimony that contended that a discount for federal income tax "proxy" of 38 percent was allowable in tax-affecting the timber company's earnings. The Court found that this represented the combined federal and state income tax burdens the owners of the partnership interests would be required to bear.[124] It also accepted the premium or add-on value for the entity's not being subject to entity level income tax.

Other discounts that can impact on valuation controversies include when the ownership interest is non-voting, the interest being valued is in shares of stock in a company which has a thin management or the presence of a key employee whose potential departure from the company, regardless of cause, would have an adverse impact on the business or its reputation. There is also the possibility that a key shareholder may have a goodwill value that is not part of the corporation's goodwill.[125] Pending and contingent liabilities, as well as legal or regulatory restrictions must be taken into account.[126]

Valuation of interests in unincorporated entities including partnerships and limited liability companies

The fair market value of a capital interest in a partnership (or membership interest in a limited liability company) is determined on essentially the same factors and valuation models and methods as in valuing shares of stock in a privately held corporation. With the Estate of Jones case and related decisions, tax-affecting partnership income or earnings models may take on acceptance, but that issue needs greater clarification and judicial acceptance.[127]

Generally, the partnership interests are not readily tradeable or sold on an exchange and therefore are eligible for a lack of marketability discount.[128] The same holds true for non-voting interests as well as minority ownership interests.[129] Again, the government's efforts to "aggregate" family ownership for gift and estate tax valuation purposes have been defeated absent a particular statutory provision or other unusual factor.[130] In many instances, the government and other expert witnesses have evaluated an interest in a family limited partnership or limited liability company as analogous to a minority interest in a closed-end mutual fund.

When restrictions are set forth in the partnership (or operating) agreement on the ability of a partner (member) to sell her interest, the restrictions may not be recognized in reducing the fair market value of the interest in question.[131] When the members of the partnership are related, buy-sell provisions or similar shareholder restrictions may not be recognized for transfer tax purposes even though such restrictions, as well as certain transfer restrictions, would be taken into account by a qualified appraiser or valuation expert.[132]

A related issue that has appeared in several court decisions is the valuation of an assignee-only

interest in a limited partnership or limited liability company. Some jurisdictions provide, both under that state's version of the uniform limited partnership act or limited liability company provisions, that a transferee or donee of a general or limited partner interest or membership interest in an limited liability company results only in the assignee's having the rights to receive distributions unless and until such transferee/done is formally admitted into the partnership. Since this is a state law imposed limitation on the nature of the interest received, the willing buyer would discount the value of the interest to take into account his inability to liquidate or withdraw from the partnership for "fair value" (let alone "fair market value"). Such assignee-only status, ad arguendo, is not an "applicable restriction" for purposes of section 2704(b) since state law default rules define the ownership handicaps suffered by the assignee. Another possible interpretation, which produces the same end result, is that the transfer of an assignee-only interest does not invoke application of section 2704(b) since the assignee-only interest is not the interest that is subject to the restriction; only the limited partnership interest is so subject.[133]

In McCord v. Comm'r,[134] the Tax Court held that the interests a husband and wife transferred in a Texas limited partnership were assignee interests and should be valued as such. The Tax Court distinguished the facts of the case from those present in Kerr, supra, since in Kerr, the donors intended to transfer all of their rights as partners or that all of the other partners had consented to the admission of the transferees as partners.[135] In Streightoff v. Comm'r,[136] decedent made a lifetime transfer of his 88.99 percent limited partnership interest in a family partnership which held a portfolio of marketable stocks and bonds. The gifts were reported as involving the transfer of assignee-only interests. An assignee of a partnership interest is entitled to receive, to the extent assigned, allocations of income, gain, loss, deduction, credit, or similar items, and to receive distributions to which the assignor is entitled, but an assignment does not entitle the assignee "to become, or to exercise rights or powers of, a partner"[137] Decedent was the grantor of the revocable trust and held section 2036 and section 2038 powers with respect to the trust, as he was also the trust's sole beneficiary and had the power to revoke, alter, or amend the trust. Applying a substance-over-form type analysis, which has not been applied with much frequency by the courts in deciding transfer tax cases,[138] the Tax Court determined that, in substance, the transfers were those of the limited partnership interests.

Relevant penalty provisions in a valuation case: the added cost of not being correct on fair market value or related items

As revamped by the 1989 Omnibus Budget Reconciliation Act of 1989,[139] the penalties for the negligent underpayment in tax, valuation overstatements, and understatements for both income and transfer tax purposes were set forth in sections 6662 and 6662A, which address accuracy-related penalties under the Code. A single accuracy-related penalty was codified into five subparts.[140]

Section 6662(a) imposes a penalty of 20 percent of the portion of an underpayment attributable to:

- Negligence or disregard of rules or regulations;
- A substantial understatement of income tax;
- A substantial valuation overstatement;
- A substantial overstatement of pension liabilities;[141]
- A substantial estate or gift tax valuation understatement;
- The disallowance of tax benefits claimed by reason of a transaction lacking economic substance per section 7701(o) or failing to meet the requirements of any similar rule;
- Any undisclosed foreign financial asset understatement; and
- Inconsistent estate tax basis.[142]

When civil fraud is involved, the civil penalty is 75 percent of the resulting underpayment in tax under section 6663. The accuracy-related penalties only is imposed on the portion of the *underpayment* in tax attributable to the specific type of

compliance violation. In other words, the penalty can only be imposed with respect to that portion of the underpayment attributable to the misconduct with respect to that amount exceeds the sum of the amount shown on the return plus amounts not shown that were previously assessed or collected without assessment over the amount of any rebates or refunds made.[143] The amount of tax shown on the return includes any additional tax shown on a qualified amended return[144] unless such additional tax is attributable to a fraudulent position on the original return.[145] The Service may impose a different accuracy-related penalty rules to different portions of the understatement for a particular tax year. The same approach can be taken with respect to that portion of an understatement attributable to an accuracy-related penalty versus the portion determined to be attributable to fraud. The substantial understatement penalty under section 6662(b)(2) applies only to underpayments in income tax.[146] The penalty is not reduced due to a net operating loss (NOL) carryback.[147] Only the failure to file penalty apply when no return has been filed.[148] For late filed returns, a failure-to-file penalty under section 6651 can apply as well as an accuracy-related penalty. In accordance with section 6665(b), the Tax Court has jurisdiction to determine, in certain instances, whether an accuracy-related penalty may be assessed for income, gift, or estate tax purposes.[149]

Substantial valuation misstatement

Under section 6662(b)(3) a substantial valuation misstatement occurs when:

- The value or the adjusted basis of any property claimed on a return of ta imposed under Chapter 1 of the Code (income, gift or estate, etc.) 150 percent or more of the amount determined to be the correct value or adjusted basis; or
- Either: (i) the price for any property or services (or for the use of property) claimed on with respect to a related party transaction under section 482 is 200 percent or more (or 50 percent or less) of the correct amount of such price; or (ii) the net section 482 transfer price adjustment for the taxable year exceeds the lesser of $5,000,000 or 10 percent of the taxpayer's gross receipts.

However, the Service cannot impose the substantial overvaluation misstatement penalty unless the underpayment related to this misconduct is greater than $5,000 (or $10,000 in the case of corporations that are not S corporations or personal holding companies).[150] There is no disclosure statement concept that will avoid or otherwise mitigate the taxpayer's liability for the substantial valuation misstatement penalty.[151]

Gross valuation misstatement

Under section 6662(h)(1), the 20 percent substantial valuation misstatement penalty is increased to 40 percent when there is a:

- Gross valuation misstatement involving a substantial valuation overstatement; [152]
- Substantial overstatement of pension liabilities; or
- Substantial estate or gift tax valuation understatement.[153]

The penalty constitutes an addition to tax. Interest on the penalty accrues from the due date of the return.[154]

A substantial overvaluation misstatement, as set forth in section 6662(h)(1), occurs when:

- The claimed value or adjusted basis on any return of tax imposed by chapter l is 200 percent or more of the amount determined to be correct; or
- Either: (i) the price for any property or services (or for the use of property) claimed on any such return in connection with any transaction between persons described in section 482 is 400 percent or more (or 50 percent or less of the amount determined under section 482 to be correct; or (ii) the net section 482 transfer price adjustment for the taxable year exceeds the lesser of $20,000,000 or 20 percent of the taxpayer's gross receipts. [155]

The penalty is applied on a property-by-property basis.[156]

Substantial gift or estate tax valuation understatement penalty

An accuracy-related penalty for a substantial estate or gift tax valuation understatement is imposed when the value of any property claimed on any gift or estate tax return is 65 percent or less of the fair market value of the correct amount.[157] When the reported or claimed value of property is determined to be 40 percent or less of the correct value, the penalty is increased from 20 percent to 40 percent.[158] The Commissioner bears the burden of proof to produce evidence as to the proper imposition of an accuracy-related penalty.[159] After the government meets its burden of going forward, the taxpayer then bears the burden of proving the penalties are inappropriate because of the reasonable cause exception.[160]

While no disclosure exception exists for estate and gift tax valuation misstatement penalties, section 6664(c)(1) sets forth that the accuracy-related penalty will not be assessed as to any portion of an underpayment for which there was "reasonable cause" and the taxpayer acted in "good faith." A comment from the legislative history to this provision is helpful as to its purpose and scope:

> The [House Ways and Means] committee is concerned that the [pre-1990] accuracy-related penalties (particularly the penalty for substantial understatements of tax liability) have been determined too routinely and automatically by the Service. The committee expects that . . . the Service [will] consider fully whether imposition of these penalties is appropriate before determining these penalties. . . . Under the waiver provision [of pre-1990] law, the Tax Court has held that it can overturn an Service determination of the substantial understatement penalty on reasonable cause and good faith grounds only if the Tax Court finds that the Service abused its discretion in asserting the penalty. The committee believes that it is appropriate for the courts to review the determination of the accuracy-related penalties by the same general standard applicable to their review of the additional taxes that the Service determines are owed.[161]

The determination of whether the reasonable cause/good faith case has been made out by the taxpayer is based on all relevant facts and circumstances.[162] The Service has the burden of moving forward with sufficient evidence to support the imposition of a penalty.[163] On the other hand, the burden of producing evidence to establish "reasonable cause" to avoid the imposition of the penalty is on the taxpayer.[164] The burden of proof is based on the preponderance of the evidence that the taxpayer acted in good faith and with reasonable cause.[165] It is a question of law, however, as to the elements that must be present to constitute reasonable case.

The court will carefully weigh the evidence to determine if in fact the taxpayer's reliance on a tax advisor, CPA, or appraiser was made so as to properly determine his tax liability, i.e., to be tax compliant.[166] It is said that such is the most important factor. [167] Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances, including the experience, knowledge and education of the taxpayer. An isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith. Reliance on an information return or on the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith. Similarly, reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect. Reliance on an information return, professional advice or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith.

What then about avoiding an accuracy-related penalty based on reliance of an appraiser's determination of value? Obtaining an appraisal by itself would appear not to be sufficient to prove up reasonable

cause. Ordinarily, such should be the case. But then should the taxpayer attempt to determine the validity or merit of the appraisal determination and methodology? If the appraiser holds himself out as a qualified expert to value, for example, interests in closely held businesses, should the taxpayer perform a due diligence inquiry concerning the appraiser before hiring him? What about the requirement of performance-added due diligence during the appraiser's gathering of information, including the interview of the client and the business or businesses the valuation concerns? What about the report itself? What if the appraisal was not first submitted in "draft" for the taxpayer and his legal counsel to review? But just like clients, lawyers can't give opinions on an opinion of value. It is not a lawyer's profession. But lawyers do evaluate a client's business operations and do business and estate planning, tax planning, and tax controversy and litigation. Maybe this a collective effort, but does the taxpayer, through aid of his legal counsel and business advisors, have to evaluate the appraisal itself to establish reasonable cause and good-faith reliance? Perhaps that is asking too much from a taxpayer. Perhaps it is enough or should be enough to determine that the appraiser was qualified, experienced, and was well-regarded among his peers and the professional community. At that point, perhaps a court in review of a gross valuation misstatement penalty may determine that the taxpayer's reliance was "reasonable" and made "in good faith."

The Service, as well as a court in review, is required to evaluate the methodology and assumptions underlying the appraisal, the appraised value, the relationship between appraised value and purchase price, the circumstances under which the appraisal was obtained, and the appraiser's relationship to the taxpayer or to the activity in which the property is used. One would assume a fair hearing on whether penalties should be imposed on an incorrect valuation position claimed on an income, gift, or estate tax return, when the appraiser has proper qualifications. At least that is a good start. But that does not ensure that the incorrect appraisal by a qualified appraiser will negate the penalty for a valuation misstatement. It is clear from the various court decisions that it will not. [168]

In Kaufman v. Comm'r,[169] the First Circuit affirmed the Tax Court's decision below that the taxpayers claimed an erroneous charitable contribution deduction of $220,000 on their 2003 and 2004 returns for a "worthless" historic preservation easement on their residence. The deduction was sourced to a historic preservation façade easement on their Boston home which they donated to the National Architectural Trust. The Tax Court found that the value of the easement was zero and that the taxpayers were liable for a 40 percent accuracy-related penalty for making a gross valuation misstatement.[170] The case proceeded to go to the appellate court, which remanded the case back in part to the Tax Court. Again, the Tax Court confirmed its holding on the zero value of the deduction (easement) and its imposition of a 40 percent penalty. Before the First Circuit for a second time, the taxpayers-appellants wanted the penalty dropped based on reasonable cause. They claimed further that the government failed to meet the procedural requirements under section 6751(b)(1).[171] Taking a second look, the First Circuit held that the Tax Court's finding that the taxpayers did not make a good faith investigation into the investigation of the value of the easement was not clearly erroneous. Upon the taxpayers' receipt of the appraisal, such information "would have put a reasonable person on notice that further investigation was required to verify the purported value of the donated easement." Indeed, the taxpayers understood that despite the "degradation" in value to their residence of donating a historic façade easement in perpetuity, the value of their residence would not decrease. The First Circuit stated that such information "[s]hould have immediately raised red flags as to whether the value of the easement was zero." The taxpayers persisted that they should not be put in the position of having to evaluate their appraiser's determination of the value of the façade easement. In response, the Court opined:

> The Kaufmans' protestations that they were unable to critically evaluate the Hanlon appraisal because they were not experts in easement

> valuation are beside the point. The Tax Court did not suggest that the Kaufmans should have been able to critique the Hanlon appraisal in a vacuum, or that they should have known from the outset that the value of the easement was zero. Rather, the court found that the Kaufmans should have recognized obvious warning signs indicating that the appraisal's validity was subject to serious question, and should have undertaken further analysis in response.
>
> The Kaufmans also miss the mark in arguing that it was conventional wisdom during the tax years in question that a conservation easement, in general, would decrease the value of a piece of property. The Service regulations themselves reject any notion that the grant of a conservation easement itself affects the fair market value. As the Scheidelman court observed, [t]o the contrary, the regulations provide that an easement that has no material effect on the obligations of the property owner or the uses to which the property may be put "may have no material effect on the value of the property." And sometimes an easement "may in fact serve to enhance, rather than reduce, the value of the property. In such instances no deduction would be allowable."

Scheidelman, 755 F.3d at 152 (footnote omitted) (quoting 26 C.F.R. § 1.170A'14(h)(3)(ii)); see also id. at 152 n. 1 (noting that "[t]his is especially true if only a simple facade easement has been granted over a property that has substantial market value because of its historic character" (alterations, citation, and internal quotation marks omitted)). Moreover, "neither the Tax Court nor any Circuit Court of Appeals has held that the grant of a conservation easement effects a per se reduction in the fair market value." Id. at 152 (alteration in original) (citations and internal quotation marks omitted); see also Nicoladis v. Comm'r, 55 T.C.M. (CCH) 624 (1988) (disclaiming adoption of any 'general '10-percent rule' . . . with respect to facade donations")." 784 F.3d at 67-68.

Among the numerous "reliance" on professional advisors claims established reasonable cause, the taxpayers also argued that by obtaining a qualified appraisal made by a qualified appraiser "[a]utomatically constitutes a good faith investigation." The First Circuit summarily rejected such position. Another portion taken from the opinion is helpful:

> This interpretation of the statute cannot be correct. section 6664(c)(2) sets forth two separate requirements that must be met in order for the reasonable cause exception to apply to a gross valuation overstatement: "(A) the claimed value of the property was based on a qualified appraisal made by a qualified appraiser, and (B) in addition to obtaining such appraisal, the taxpayer made a good faith investigation of the value of the contributed property." The Kaufmans' reading would render the second requirement meaningless, in violation of the rule that "a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause is rendered superfluous, void, or insignificant." Young v. United Parcel Serv., Inc., ___ U.S. ___, 135 S. Ct. 1338, 1352 (2015) (citations and internal quotation marks omitted) (declining to read the second clause of the Pregnancy Discrimination Act as "simply defin[ing] sex discrimination to include pregnancy discrimination" because "[t]he first clause accomplishes that objective").

Simply obtaining an appraisal is not the same as *reasonably relying* on that appraisal. The Kaufmans concede as much in their reply brief, acknowledging that "'obtaining' a qualified appraisal alone will not satisfy the good-faith investigation requirement, nor will 'unreasonable' reliance." There may well be situations in which the taxpayer need do little more than read an appraisal and note that there is no other evidence that reasonably casts doubt on the accuracy of the appraisal. Here, however, the Tax Court supportably found that the Kaufmans obtained a qualified appraisal from a qualified appraiser, but that other facts available to the Kaufmans should have alerted them that it was not reasonable to rely on that appraisal."

The First Circuit's opinion in Kaufman v. Comm'r, provides a detailed and thoughtful analysis on when a taxpayer may be penalized in a civil tax case for the valuation mistakes or errors made by his appraiser. As stated by the Court, "simply obtaining an appraisal is not the same as *reasonably relying* on that appraisal.[172]

In Part Two of this two-part article, the discussion will address the role of expert testimony, and, in particular, the expert valuation witness, in a valuation case before the United States Tax Court. Discussion will involve the process of selecting an expert, the expert report, discovery rules, challenges to the admission of expert testimony and other procedural and tax litigation factors to consider.

Notes

1 Alexandervich v. Gallagher Bros. Sand Gravel, 298 F.2d 918 (2nd Cir. 1961) (former IRS agent-accountant employed by tax law firm, subpoenaed to testify before a grand jury investigating law firm's client for alleged federal income tax violations, accountant refused to answer questions on the basis of the attorney-client privilege and was held in contempt and sentenced to one year's imprisonment; Second Circuit, per Judge Friendly, reversed and held that the attorney-client privilege extends to communications made by a client to an accountant in attorney's employ incident to the client's obtaining legal advice from the attorney, and remanded the proceeding for a determination of the circumstances under which the client's communication reached the witness, even though the witness, despite the trial judge's refusal to consider evidence of these circumstances, should have made an offer of proof in order to make a record for the reviewing court).

The common practice, of course, is for counsel to hire a valuation consultant or other professional whose efforts are sought to help legal counsel advise his client and to have in place a formal written agreement with respect to such work product. See Federal R. Civ. P. 26(b)(3)(A); Fed. Rule Crim. P. 16(b)(2)(A). See Jerald David August, "Attorney-Client Privilege and Work Product Doctrine in Tax Controversies and Tax Litigation," ALI CLE (12/15/2017) (WESTLAW).

2 See Rhodes v. E.I. Du Pont De Nemours & Co, 558 F. Supp. 2d 660, 663 (S.D. Va. 2008); Grant Thornton, LLP v. FDIC, 297 F. Supp. 2d 880 (S.D. Va. 2004); Wang Laboratories, Inc. v. Toshiba, 762 F. Supp. 1246 (E.D. Va. 1991) for an informative review of what is potentially at stake in this area see Nina A. Vershuta, "New Rules of War in the Battle of the Experts: Amending the Expert Witness Disqualification Test for Conflicts of Interest," 31 Brook. L. Rev. 377 (2016).

3 See Tax Court Rule 124 (parties can jointly agree in a docketed case at any time prior to trial to submit any factual dispute to binding arbitration). After the motion for arbitration is filed, the matter will be assigned to a judge or special trial judge. If the motion is granted, an order will be issued appointing the arbitrator and providing such directions as the court deems necessary and appropriate. Tax Court Rule 124(b)(3); Duncan v. Comm'r, 121 T.C. 293 (2003). The findings of the arbitrators will be required to be reported promptly to the court. The arbitrator is expected to provide only the valuation figure or other factual determination, with no accompanying explanation. If no other disputed issues remain in the case, the Tax Court will enter a decision or direct the filing of a Rule 155 computation. Under Tax Court Rule 124(b), the parties may, by joint or unopposed motion, resolve issues through voluntary nonbinding mediation. Such motion may be made at any time after a case is at issue and before the decision of the case is final. Under Tax Court Rule 124(c), the arbitration and mediation procedures set forth in the rule are not all inclusive and another form of voluntary disposition of the case may be appropriate.

4 See Fed. R. Evid. 408, Compromise Offers and Negotiations.

5 Please note that the author's efforts in issuing this analysis are intended solely for informational and educational purposes only, and may not be relied upon as "legal advice" worthy of reliance. While this point may be self-evident to many who may view this article, it is better to specifically mention it anyway. All references to sections (§§) contained in this article are, unless otherwise provided, with respect to the Internal Revenue Code of 1986, as amended from time to time and the Treasury Regulations issued thereunder at the time that this article is submitted for publication, i.e., July, 2020.

6 Fed. R. Evid. 701. See, e.g., Giosband v. Watts Detective Agency, Inc. 21 B.R. 983 (D.C. Mass. 1981).

7 See Skolnick v. Comm'r, T.C.M. 2019-64 (expert report on value of horses rejected as report did not set forth any facts or data on which he relied. See FREV 702(b); Tax Court Rule 143(g)(1)(B); See also Daubert v. Merrell Dow Pharm., Inc., 509 U.S. 579, 597 (1993); Kumho Tire Co. v. Carmichael, 526 U.S. 137, 149 (1999) (extending the principles of Daubert to all expert testimony, including non-scientific expert testimony). The admissibility of expert testimony will be discussed further in Part Two of this article.

8 See, e.g., Belair Woods, LLC v Comm'r, 145 T.C. No. 1 (2020); Zarlengo v. Comm'r, T.C.M. 2014-161; Nancy A. McLaughlin, "Conservation Easements and the Valuation Conundrum," 19 Fla. Tax. Rev. 225 (2016).

9 See, e.g, Altera Corporation v. Comm'r, 145 T.C. 91 (2015) (cost-sharing agreement); Sunstrand Corporation and Subsidiaries v. Comm'r, 96 T.C. 226 (1991) (transfer price of intangibles); OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations," (July 2017); OECD-G20 Base Erosion and Profit Shifting Project, Action 6 (9/16/2014). See also § 6662(e)(accuracy-related

penalty for valuation understatements resulting from flawed transfer pricing amounts subject to § 482); Rev. Proc. 2015-40, 2015 USTR ¶83,308. Exceptions are applicable for reasonable cause, good-faith pricing claims by the taxpayer and certain foreign-to-foreign adjustments. See §§ 6662(e)(3)(B)(i), (ii). For discussion in this area when § 6662(e) was enacted into law, see Smith, "Documentation Needed to Avoid Penalties Specified by Transfer Pricing Temp. Regs.," 80 J. Tax'n 304 (1994); John B. Magee, F. Scott Farmer & Robert A. Katcher, "If at First You Don't Succeed: The New Transfer Pricing Penalty Regulations," 62 Tax Notes 899 (Feb. 14, 1994); Kies & Conroy, "Avoiding the Penalty on Related-Party Transfers," 62 Tax Notes 909 (Feb. 14, 1994); Alan Lederman & Bobbe Hirsh, "Transfer Pricing Penalty Regs. Create Gordian Knot of Compliance," 5 J. Int'l Tax'n 176 (1994).

10 See Treas. Reg. § 1.170A-1(c)(2).

11 § 1374(d)(1), § 1374(c)(2)(A).

12 See, e.g., Estate of Kelley v. Comm'r, 63 T.C. 321, 323–324 (1974); Haygood v. Comm'r, 42 T.C. 936, 946 (1964); Laughinghouse v. Comm'r, 80 T.C. 425, 431 n. 8 (1983); Davies v. Comm'r, 40 T.C. 525, 530 (1963); Story v. Comm'r, 38 T.C. 936, 941 (1962); Todd v. Comm'r, T.C.M. 2011-123, aff'd per curiam, 2012 WL 3530259 (5th Cir. 2012).

13 See, e.g., Treas. Reg. § 20.2031-1(b); Anselmo v. Comm'r, 757 F.2d 1208 (11th Cir. 1985)

14 See, e.g., Zarlengo v. Comm'r, T.C.M. 2014-161 (value of donated conservation easement challenged by Service; taxpayer subject to strict liability for gross valuation misstatement penalties).

15 § 6662(e).

16 § 6662(b)(3). See also Grapevine Imports Limited v. U.S., 107 A.F.T.R. 2d 2011-564 (CA FC 2011) (overstatement of basis constitutes omission from gross income for purposes of the six year statute of limitation on assessment under § 6501(e)(1)(A).

17 § 6664(c)(3); Treas. Reg. § 1.6662-5(f)(1); Plateau Holdings, LLC Waterfall Development Manager, LLC Tax Matters Partner v. Comm'r, T.C.M. 2020-93; RERI Holdings I, LLC v. Comm'r, 149 T.C. 1 (2017).

18 Estate of Heckscher v. Comm'r, 63 T.C. 485 (1975). In large cases, i.e., deficiencies in tax of more than $1 million is in dispute the pre-trial development of the case is given closer inspection by the Court and it has developed a procedure by which a judge may be specially assigned to the case at an early stage, rather than delaying until the case is calendared for trial. In large part, this procedure reflects that such large cases will not be heard on the normal calendar call because of the significant trial time often required. This large case procedure allows the Court to manage these cases more actively prior to trial. The procedure is not contained in the Tax Court Rules. See Dunn Trust v. Comm'r, 86 T.C. 745 (1986).

19 See, e.g., Parker v. Comm'r, 86 T.C. 547, 560-565 (1986); Snyder v. Comm'r, 86 T.C. 567, 582-587 (1986).

20 74 T.C. 441 (1980), acq. 1982 WL 600357.

21 74 T.C. at 452.

22 Fed. R. Evid. 702.

23 Estate of Christ v. Comm'r, 480 F.2d 171, 174 (9th Cir. 1973), aff'g 54 T.C. 493 (1970); Anderson v. Comm'r, 250 F.2d 242, 249 (5th Cir. 1947).

24 Helvering v. National Grocery Co., 304 US 282 (1939); Silverman v. Comm'r, 538 F.2d 927, 933 (2d Cir. 1976); In re Williams' Estate, 256 F.2d 217, 219 (9th Cir. 1958).

25 See Chiu v. Comm'r, 84 T.C. 722 (1985); Dean v. Comm'r, 83 T.C. 56, 75 (1984); Fuchs v. Comm'r, 83 T.C. 79, 99 (1984).

26 Flora v. U.S., 362 US 145, 158 (1960). See Harold Dubroff & Brant J. Hellwig, "The United States Tax Court: An Historical Analysis" (2d ed. 2015), available at https://www.ustaxcourt.gov/book/Dubroff_Hellwig.pdf.

27 H. Rep. 179, 68th Cong., 1st Sess. 7. Revenue Act of 1924, tit. 9., c. 234, 43 Stat. 253, 336, § 990. Where the Board of Tax Appeals determined there was a deficiency in tax, the amount so determined was assessed and paid upon notice and demand from the Service. No part of the amount determined as a deficiency by the Commissioner, but disallowed as a deficiency by the Board, could be assessed, but the Commissioner, notwithstanding the decision of the Board against him, could still bring a suit in a proper court against the taxpayer to collect the alleged deficiency. There was under the Act of 1924 no direct judicial review of the proceedings before the Board of Tax Appeals; however, each party had the right to seek separate action by a court of competent jurisdiction to test the correctness of the Board's action. Such court proceedings were to be begun within one year after the final decision of the Board. The Revenue Act of 1926 revised the rules on direct judicial review of the Board of Tax Appeals' decision and enlarged the original jurisdiction to determine not only whether there was a deficiency in tax owed but also whether the tax had been overpaid.

The background of the Board of Tax Appeals is discussed by the Supreme Court in Old Colony Trust Co. v. Comm'r, 59 S. Ct. 299 (1929) (Supreme Court confirmed its jurisdiction, i.e., that the "case and controversies" requirement of the U.S. Constitution was satisfied, to review a decision rendered by the First Circuit Court of Appeals to which court the taxpayer brought an appeal from an adverse determination of additional income taxes with respect to compensatory payments received in 1919 and 1920).

28 All references to sections (§§) contained in this article are made with respect to the Internal Revenue Code of 1986, as amended from time to time, and the regulations promulgated by the U.S. Treasury and the Internal Revenue Service.

29 See Old Colony Trust Co. v. Comm'r, 49 S. Ct 499 (1929).

30 See §§ 7441-7448. See Kuretski v. Comm'r, 755 F.3d 929 (CADC 1014); Nash Miami Motors, Inc. v. Comm'r, 358 F.2d 636 (5th Cir. 1966); While it is not an Article III court, the Tax Court acts in the same manner as a federal district court proceeding but without a jury. The Tax Court only has such powers as are granted to it by the Congress. Knapp v. Comm'r, 90 T.C. 430 (1988), aff'd, 867 F.2d 749 (2nd Cir. 1969); Kazi v. Comm'r, T.C.M. 1991-37, aff'd sub nom. Gardner v. Comm'r, 954 F.2d 836 (2nd Cir. 1992); Savage v. Comm'r, 112 T.C. 46 (1999). There are 19 judges appointed

by the President and Senior Judges as well as Special Trial Judges. Tax Court judges serve 15-year terms. See § 7443.

31 § 6214(a) (Tax Court has jurisdiction to redetermine the correct amount of the deficiency). See §§ 6851 (termination assessment), 6861 (jeopardy assessment), 7476 (declaratory actions involving exemption organizations, pension plans, and exempt status of certain bonds). See also § 7429 for jeopardy and termination assessment procedures. See Laing v. U.S., 423 US 161, 165-166 (1976).

32 See Kurtzon v. Comm'r, 17 T.C. 1542 (1952) (deficiency in particular tax year taking into account net operating loss carryback and rebates); Levinson v. U.S., 496 F.2d 651 (3d Cir. 1974).

33 Treas. Reg. § 301.6211-1(a).

34 § 6213(a).

35 § 6214(a). See Ferrill v. Comm'r, 684 F.2d 261 (3d Cir. 1982) aff'g ¶79,501 P-H Memo T.C. (Third Circuit held that Tax Court below did not abuse discretion in permitting IRS at trial to change theory and assert additional deficiency when it learned additional facts about transaction for first time from taxpayers' response to interrogatories); Henningsen v. Comm'r, 243 F.2d 954, 959 (4th Cir. 1957). See also Tax Court Rules 161 (motion for reconsideration of findings or opinion); 162 (motion to vacate or revise decision).

36 Tax Court Rule 142(a). The Tax Court may, however, deny a party the opportunity to raise new issues where the opposing party will be prejudiced. Tax Court Rule 41 allows the petitioner to file an amended Petition once before the answer of the government or other party is served. Otherwise, a party can amend only by written consent of the other party or by motion granted by the court. See Musa v. Comm'r, 854 F.3d 934 (7th Cir. 2017). See Tax Court Rule 41(b)(1). The Tax Court cannot allow any amendment which would confer jurisdiction by consent of the parties where the court otherwise does not have jurisdiction. See, e.g., O'Neill v. Comm'r, 66 T.C. 105 (1976).

37 § 6512(b)(1). See Belloff v. Comm'r, 996 F.2d 607 (2nd Cir. 1993); Russell v. Comm'r, 678 F.2d 782 (9th Cir. 1982); Judge v. Comm'r, 88 T.C. 1175 (1987)(acq.).

38 See Gerald Kafka & Rita Cavanagh, "Litigation of Federal Civil Tax Controversies," (WG&L) ¶¶2.02, 2.02, 2.03, 13.15. See also Tax Court Rule 156 (estate tax deduction developing at or after trial).

39 § 6603 (deposits made to suspend running of interest on potential underpayments, etc.); Rev. Proc. 2005-18, 2005-13 IRB 798, §§ 5, 9; Rev. Proc. 84-58, 1984-2 CB 501; Rev. Proc. 2002-26, 2002-1 CB 746 §§ 6401(a), 6502(a), 6501(a), 6603; Cohen v. U.S., 995 F.2d 205 (2nd Cir. 1996); Principal Life Insur. Co. v. U.S., 95 Fed. Cl. 796 (2010).

40 26 U.S.C. § 7422(a); 28 USC § 1346(a)(1)(refund suits before federal district court for any erroneously or illegally assessed or collected internal revenue tax or penalty); §§ 6511(a), 6532(a); DiNatale v. U.S., 59 A.F.T.R. 2d 964 (1987) (Court of Federal Claims has concurrent original jurisdiction with federal district courts over refund suits; taxpayer filed to satisfy full payment rule case was therefore dismissed for lack of jurisdiction); Frise v. U.S., 54 AFTR2d 5504 (Cl. Ct. 1984). For a case that reveals the potential harshness of the full payment rule in less obvious circumstances see Lawrence v. U.S., 2015-1 U.S.T.C. ¶50.164 (11th Cir. 2015 (unpub. op.) The Board of Tax Appeals (U.S. Tax Court allowed for taxpayers to avoid having to pay the tax and additions to tax in issue, including interest, before litigating.

41 362 U.S. 145 (1960), aff'g on reh'g 357 US 63 (1958); Magee v. U.S., 24 Cl. Ct. 511 (1991) (jurisdiction granted where deficiency and penalty paid but not interest); Tonasket v. U.S., 298 Ct. Cl. 709 (1978). The Tax Court's jurisdiction is based on there being a "deficiency" in tax so that where there are assessable penalties advanced by the government, but no deficiency in tax, jurisdiction will be declined. See, e.g., Smith v. Comm'r, 133 T.C. 424 (2009) (no jurisdiction for lack of a "deficiency" in a § 6707A failure to disclose reportable transaction penalty case where the notice of deficiency was still issued); LTV Corp. v. Comm'r, 64 T.C. 589 (1975) (removal of deficiency by Service's agreement to net operating loss carryback for the year before the court).

42 See Kell-Strom Tool Co. v. U.S., 2-5 F. Supp. 190 (D. Conn.1962); Shore v. U.S., 9 F.3d 1524 (1993) (full payment rule relates to the assessment of tax but not penalties and interest provided the taxpayer prepays the full tax assessed); Estate of Baumgardner v. Comm'r, 85 T.C. 445, 461 (1985); Payne v. U.S., 88-2 U.S.T.C. ¶ 9556 (D Vt. 1988) (US Dept. Justice Tax Division cited with approval that "only the amount of the tax assessed need be paid … Any amount of interest is not included in this total"; CCDM (35) (18) (11) 3 (2) (b) (Oct. 7, 1988). When the refund suit is properly and timely filed the government will counterclaim for the amount of interest assessed.

43 A refund suit must be commenced within two years after a notice of disallowance is mailed by certified or registered mail by the Service to the taxpayer. § 6532(a)(1); Rosser v. U.S., 9 F.3d 1519 (11th Cir. 1963). Where the taxpayer signs a waiver of the requirement of notice of disallowance, the two-year period commences when the waiver is filed. § 6532(a)(3). If a disallowance notice is not sent, there is evidently no limit on when a refund suit must be filed. See 28 U.S.C. § 2401(a) for example which provides "every civil action commenced against the United States shall be barred unless the complaint is filed within six years after the right of action first accrues." Were this provision to control where the taxpayer receives no notice of disallowance, the refund suit must be filed within six year and six months from the date that the claim is filed. The courts have not agreed on whether 28 U.S.C. § 2401(a) applies where there is no notice of disallowance mailed to the taxpayer after filing a claim for refund. Compare Detroit Trust Co. v. U.S. 130 F. Supp. 815 (Cl. Ct. 1955) with Breland v. U.S., 2011-2 U.S.T.C. ¶50,632 (N.D. NY). See Robin Greenhouse, Andrew R. Roberson & K. Christy Vouri, "Equitable Tolling and Tax Refund Suits," 148 Tax Notes 767 (Aug. 17, 2015); Adam R. F. Gustafson, "An Outside Limit for Refund Suits: The Case Against the Tax Exception to the Six-Year Bar on Claims Against the Government," 90 Or. L. Rev. 191 (2011).

44 Treas. Reg. § 301.6402-2(b)(1). The waiver doctrine is an exception to the requirement in Treas. Reg. § 301.6402–2(b)(1) that each claim be "set forth in detail." See Angelus Milling, Co. v. Comm'r, 325 U.S. 293, 296, 65 S. Ct. 1162 (1945). Where, for example, the taxpayer "files a timely formal claim but fails to include the specific claim for relief,

the claim may nonetheless be considered timely if the Service consider[ed] that specific claim within the limitations period." Cencast Services LP v. U.S., 34 Fed. Cl. 425 (2010), aff'd, 729 F.3d 1352 (Fed. Cir. 2013).

45 See, Free-Pacheco v. U.S., 117 Fed. Cl. (2014) (discussion of doctrine of variance); First Nat'l Bank v. U.S., 727 F.2d 741, 744 (8th Cir. 1984); Ottawa Silica Co. v. U.S., 699 F.2d 1124, 1138 (Fed. Cir. 1983); Union Pac. R.R. v. U.S., 389 F.2d 437, 442 (Ct. Cl. 1968); Payne v. U.S. 500 F. Supp. 571 (D. Colo. 1980). See Tucker v. Alexander, 275 U.S. 228, 231 (1927) (variance rules "are devised, not as traps for the unwary, but for the convenience of government officials in passing upon claims for refund and in preparing for trial"). But see Burlington N. Inc. v. U.S., 684 F.2d 866 (Ct. Cl. 1982) (considering whether argument advanced by taxpayer advanced new grounds and new facts). True v. U.S., 190 F.3d 1165 (10th Cir. 1999) (taxpayer's failure to raise issue of collateral estoppel in refund claim constituted a variance). The government's argument of "variance" is an affirmative defense which must be plead in its answer and if not objected to may be considered as waived even during administrative consideration of the written refund claim by allowing the taxpayer's presentation of new grounds without objection. Union Pac. R.R. v. U.S., 389 F.2d 437, 442 (Ct. Cl. 1968)

46 An appeal of a Tax Court decision requires the filing of a notice of appeal with the Clerk, Tax Court within 90 days after the decision is entered. § 7483; Tax Court Rule 190(a). If a timely notice of appeal is filed by one party, then any other party may take an appeal by filing a notice of appeal within 120 days after the Court's decision is entered. See also Fed. R. App. P. 13 and 14.

Under Fed. R. App. P. 4(a)(1)(B), a party must filed a notice of appeal in a civil case in which the United States is a partner "within 60 days after the judgment or order appealed from is entered." This is a strict requirement. Bowles v. Russell, 551 U.S. 205, 209-10 (2007). Nevertheless, a district court may reopen the time to file an appeal under certain conditions or extend to file a notice of appeal in certain instances. See U.S. v. Hockensmith, 105 A.F.T.R. 2d 2010-1703 (D.C. Pa. 2010).

47 § 7482(a)(1). Decisions of the US Court of Federal Claims are reviewable by the Court of Appeals for the Federal Circuit. There are 13 US Courts of Appeal, 11 judicial circuits, one for the District of Columbia and the other for the Federal Circuit Court of Appeals. Golsen v. Comm'r, 54 T.C. 742 (1970); aff'd, 445 F.2d 985 (10th Cir. 1971); John Deere Co. v. Graham, 333 F.2d 529 (8th Cir. 1964), aff'd, 383 US 1 (1966). In Golsen, supra, the Tax Court announced that it follow decisions of the Court of Appeals for the same circuit within which the case arises provided such precedent is directly on point; the rationale was to apply taxing statutes uniformly over the nation. In other instances, the Tax Court, as a national tribunal, will follow its own precedent or be free to follow a Court of Appeals decision where the case is not appealable. In some instances, however, where there are two or more taxpayers before the Court, the case may be appealable to more than one Circuit Court of Appeals. The Tax Court in Golsen did not have that situation before it in announcing its rule of judicial administration.

48 28 U.S.C. § 1295. The Federal Circuit has adopted as precedent decision of the U.S. Court of Claims issued prior to September 30, 1982. South Corp. v. U.S., 690 F.2d 1368, 1370-1371 (Fed. Cir. 1982). The Court of Federal Claims as well as the Federal Circuit Court of Appeals is not obligated to follow the decision of another Circuit Court of Appeals or the United States Tax Court.

49 Dobson v. Comm'r, 321 U.S. 231 (1944).

50 See Fed. R. Civ. P. 51(b).

51 See Tax Court Rule 140; 28 USC § 2505 (any judge of the United States Court of Federal Claims may sit at any place within the United States to take evidence and enter judgment); 28 USC § 1391 (venue in federal district court).

52 See Benson v. Comm'r, T.C.M. 2004-72; Knott v. Comm'r, 67 T.C. 681 (1977), acq. 1979-1 CB 1; Rev. Rul. 79-9, 1979-1 CB 125. Under § 170, a donor must substantiate the value of an in-kind property contribution having a value of more than $5,000 by at least one qualified appraisal. See also § 170(f)(11); Treas. Reg. § 1.170A-13(c)(1)(i). The scope of the term "similar items of property" for purposes of the obligation to obtain a qualified appraisal means property of the same generic category or type, such as stamps, coins, lithographs, paintings, photographs, books, non-publicly traded stock, publicly traded stock, land, buildings, clothing, jewelry, furniture, electronic equipment, household appliances, toys, everyday kitchenware, china, crystal, or silver.

53 See, e.g., Estate of Koons v. Comm'r, 686 Fed. Appx. 779 (11th Cir. 2017) (non.pub.).

54 Also included are deficiencies in certain excise taxes involving private foundations and pension plans.

55 § 6213(a). There are exceptions on the restrictions on assessment without providing a 90-day letter to the taxpayer with respect to: (i) assessments from mathematical or clerical errors; (ii) certain requests for abatement of assessment of mathematical or clerical errors; (iii) as to tentative carryback or refund adjustments. See § 6213(b).

While a deficiency in income tax is based, in general, with respect to a discrete taxable year reporting period, the gift and estate tax, since 1976, is combined as a unified wealth transfer system with a single rate schedule and technically is a cumulative or graduated tax on lifetime taxable transfers and transfers occurring by reason of death. Pub. L. No. 94-455, § 2001(a)(1), 90 Stat. 1846 (Oct. 4, 1976). Taxable lifetime gifts are cumulated and subject to an increasing set of bracket rates which achieve, under current law, a maximum rate of transfer tax of 40 percent [check] for lifetime gifts and transfers taking effect at death in excess of $3 million.

56 Mandelbaum v. Comm'r, T.C.M. 1995-255, aff'd, 91 AF.3d 124 (3d Cir. 1996) (discount for lack of marketability discount on transfer by gift of closely held stock; Court cited its same thoughts on the subject made in Buffalo Tool & Die Manufacturing Co. v. Comm'r, 74 T.C. 441, 452 (1980); Messing v. Comm'r, 48 T.C. 502, 512 (1967)). Due to the inherent lack of precision involved in making a judicial determination of fair market value, the Tax Court has encouraged taxpayers and the Service to attempt to compromise their respective positions to resolve a valuation dispute

without trial. In Buffalo Tool & Die Manufacturing Co., Inc., supra, the Tax Court stated:

> We are convinced that the valuation issue is capable of resolution by the parties themselves through an agreement which will reflect a compromise Solomon-like adjustment, thereby saving the expenditure of time, effort, and money by the parties and the Court—a process not likely to produce a better result. Indeed, each of the parties should keep in mind that, in the final analysis, the Court may find the evidence of valuation by one of the parties sufficiently more convincing than that of the other party, so that the final result will produce a significant financial defeat for one or the other, rather than a middle-of-the-road compromise which we suspect each of the parties expects the Court to reach. If the parties insist on our valuing any or all of the assets, we will. We do not intend to avoid our responsibilities but instead seek to administer to them more efficiently—a factor which has become increasingly important in light of the constantly expanding workload of the Court. 74 T.C. at 452.

57 See, e.g., Bank One Corporation v. Comm'r, 120 T.C. 174 (2003) (highlighted difference between fair market value and fair value pertinent to state law concepts).

58 §§ 2031(a), 2032, 2512; Treas. Regs. §§ 20.2031-1(b), 20.2031-2, 25.2512-1. There are other regulations which set forth, in general, the same standard. See, e.g., Treas. Regs. §§ 170A-1(c)(2) (charitable contributions); 1.412(c)2)-1(c)(1) (qualified plan asset valuation); 1.704-4(a)(3), 1.737-1(b)(2) (pertaining to partnership distributions); 1.877A; 1.1060; 1.338; See Amerada Hess Corp. v. Comm'r, 517 F.2d 75, 83 (3d Cir.), cert. denied, 423 U.S. 1037 (1975) (income tax) (same standard use in determining amount realized under § 1001(b)). Where corporate stock is sold on a public exchange the trading price on the applicable sale date is the value used for transfer tax purposes

59 The leading treatise on the Federal transfer taxation is Stephens, Maxfield, Lind, & Calfee, Federal Estate and Gift Taxation, (Wg&L Tax Series, 6th ed. 1990), see in particular, ¶4.02 (fair market value). Another learned treatise describes the characteristics of the willing buyer-willing seller standard. See Bittker & Lokken, Federal Taxation of Income, Estates and Gifts (WG&L), ¶135.1. See also Wendy C. Gerzog, "McCord and Postgift Events," 113 Tax Notes 349 (Oct. 23, 2006); Wendy C. Gerzog, "McCord: Value of Gifts Must Be 'Tax Affected,'" 113 Tax Notes 913 (Dec. 4, 2006).

60 See Comm'r. v. Marshall, 125 F.2d 943, 946 (2d Cir. 1942); U.S. v. Land, 303 F.2d 170, 172 (5th Cir. 1962), cert. denied, 371 U.S. 862 (partnership interest valued without regard to restriction lapsing at death). But see Estate of Noble v. Comm'r, T.C.M. 2005-2 (best indicum of fair market value of decedent's 11.6 percent interest in privately traded stock in the record was price at which majority shareholder purchased decedent's shares from her estate 14 months after date of death); Polack v. Comm'r, 366 F.3d 608 (8th Cir. 2004); aff'g T.C.M. 2002-145. An event occurring after a valuation date, even if it is unforeseeable as of the valuation date, may be, however, probative of FMV as of the valuation date to the extent it is relevant to establishing what a willing buyer would have paid for the property. Estate of Gilford v. Comm'r, 88 T.C. 38, 52–54 (1987); Estate of Jephson v. Comm'r, 81 T.C. 999, 1002–1003 (1983).

61 1959-1 CB 237, modified by Rev. Rul. 65-193, 196502 CB 370; amplified in Rev. Rul. 77-287, 1977-2 CB 319 (stock subject to SEC restrictions), amplified in Rev. Rul. 80-214 (valuation of paired or stapled stock); Rev. Rul. 68-609, 1969-2 CB 42 (application to income tax situations).

62 Rev. Rul. 59-60, supra, § 3.01.

63 Estate of Simplot v. Comm'r, 249 F.3d 1191, 1195 (9th Cir. 2001). The government's efforts to combine family members' stock holdings in determining whether the combined group had "control" over the corporation or business entity did not meet with success in the courts. Bright's Est. v. U.S., 658 F.2d 999 (5th Cir. 1981) (en banc) (estate tax), vacating 619 F.2d 407 (5th Cir. 1980); Propstra v. U.S., 680 F.2d 1248 (9th Cir. 1982) (estate tax); Andrews' Est. v. Comm'r, 79 T.C. 938 (1982) (estate tax). See generally Note, "Estate of Bright and Propstra: Rejection of Family Attribution in Estate Valuation," 2 Va. Tax Rev. 357 (1983). See Rev. Rul. 93-12, 1993-1 CB 202 (Service will follow Bright, Propstra, and Andrews; where sole owner of corporation's stock gives 20 percent of stock to each of five children, "the factor of corporate control in the family is not considered in valuing each transferred interest," and "a minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held by family members, would be part of a controlling interest"); Caudill & Budyak, "New IRS Position on Valuation May Result in Reduced Marital and Charitable Deductions," 79 J. Tax'n 176 (1993); Hall, "The Service Limits Discounts for Undivided Interests in Real Estate: Why the Service Is Wrong," 21 J. Real Est. Tax'n 344 (1994).

64 Chapter 14 of the Code, of course, contains artificial valuation factors that in many cases require, as a matter of law, that certain key valuation factors be ignored. This article does not highlight or examine Chapter 14 of the Code. See, e.g., Stephens, Maxfield, Lind & Calfee, supra, ¶19.01; See Zaritsky & Aucutt, Structuring Estate Freezes Under Chapter 14 (Thomson Reuters/Tax & Accounting 1993) for a comprehensive discussion of Chapter 14 together with numerous forms, and Bogdanski, Federal Tax Valuation, Chapters 4–6 (Thomson Reuters/Tax & Accounting 1996). See also Louis S. Harrison, "The Real Implications of the New Transfer Tax Valuation Rules—Success or Failure?" 47 Tax Law. 885 (1994). Jerald David August "Artificial Valuation of Closely Held Interests: Section 2704," 22 Est. Plan. 339 (1995).

65 See Whitehouse Hotel Limited Partnership v. Comm'r, 615 F.3d 321, 335 (5th Cir. 2010), on remand 139 T.C. 304 (2012); Estate of Dunn v. Comm'r, 301 F.3d 339 (5th Cir. 2002).

66 See, e.g., Estate of Linde v. Comm'r, 8 T.C.M. 1102 (1949); Goss v. Fitzpatrick, 97 F. Supp. 765 (D. Conn. 1951).

67 See, e.g., Estate of Smith v. Comm'r, T.C.M. 1998-368 (asset value approach given greatest weight in valuing corporation engaged in farming operations as real property); Estate of Richmond v. Comm'r, T.C.M. 2014-26 (net asset value used to value stock of personal holding company owning portfolio of publicly traded securities); Estate of Andrews v. Comm'r, 78 T.C. 938 (1982). With respect to income-producing real property methods for valua-

tion include the comparable sales method, the income method, and replacement-cost methods. See Hilborn v. Comm'r, 85 T.C. 877 (1985); USPAP Standards Rule 1-4. For valuing real property, the comparable sales method involves examination of similar property sold in geographic proximity to one another about the same time. See United States v. 320.0 Acres of Land, 605 F.2d 762 (9th Cir. 1979); United States v. Trout, 386 F.2d 216 (5th Cir. 1967). The income method analyzes data from comparable properties to determine the property's earnings capacity, operating expenses, and rates of capitalization and discount. This information is combined with any "reasonably clear and appropriate evidence" of future income potential and expenses to estimate the property's value. USPAP Standards Rule 1-4(c); United States v. 6.45 Acres of Land, 409 F.3d 139 (3d Cir. 2005) (explaining that the "income capitalization approach" determines fair market value by dividing the "net income that a tract of land can produce in a typical year" by "a factor called a "capitalization rate," which is a "ratio representing the relationship between the land's annual net income and its value"). The replacement cost method requires the determination of the underlying property's value as if there were no improvements made on the property. Then the cost to construct the property's improvements as new are taken into account. A separate determination is made of the present worth of the improvements on the property. In reaching the replacement-cost valuation, the present worth of the existing improvements are subtracted from the new cost of the improvements. The result is the replacement-cost value. USPAP Standards Rule 1-4(b); N. Natural Gas v. U.S., 470 F.2d 1107 (8th Cir. 1973).

68 A somewhat recent Delaware Chancery Court decision, Judge Chandler observed that for Delaware courts, the discounted cash flow analysis has become the principal valuation methodology for determining going concern value of an entity in a "fair value" type proceeding. Cede & Co. v. JRC Acquisition Corp., No. 18658-NC, 2004 WL 286963, at 2 (Del. Ch. Feb. 10, 2004) ("In recent years, the DCF valuation methodology has featured prominently in this court because it ... merits the greatest confidence within the financial community" (internal quotation marks omitted).). See also, Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1963); Del Code Ann. Tit 8, § 262 (2001); Hamermesh and Wachter, "The Fair Value Cornfields in Delaware Appraisal Law," 31 J. Corp. L. 119 (Fall 2005).

69 See Northern Trust Co. v. Comm'r, 87 T.C. 349 (1986).

70 Rev. Rul. 68-609, 1968-2 CB 327; VGS Corp. v. Comm'r, 68 T.C. 563 (1977).

71 See, e.g, Levenson v. Comm'r, 18 T.C.M. 535 (1959), rem'd, 282 F.3d 581 (3rd Cir. 1960); Estate of Goar v. Comm'r, 9 T.C.M. 854 (1950); Harrison v. Comm'r, 17 T.C.M. 776 (1958); Central Trust Co. v. U.S., 305 F.2d 393 (Ct. Cl. 1962).

72 See, e.g., Russell v. U.S., 260 F. Supp. 493 (N.D. Ill. 1966) (comparables selected by taxpayer's expert rejected); Estate of Newhouse v. Comm'r, 94 T.C. 193 (1990), nonacq., 1991-1 C.B. 1; Estate of Lauder v. Comm'r, T.C.M. 1994-527; Estate of Leichter v. Comm'r, T.C.M. 2003-66.

73 Note again the various factors cited in Rev. Rul. 59-60, supra.

74 See Alerding, et al, Research Institute of America: Tax Advisors Planning System, 9 Valuation of a Closely Held Business, § 5.02(A).

75 1983-2 CB 170.

76 See Treas. Reg. § 25.2512-2(f)(2).

77 But see §§ 2701(a), 2701(d).

78 Various rights afforded to shareholders or partners of a family business or investment enterprise may be exercised in the discretion of the holder and/or the entity. Such rights would most likely be taken into account under the willing buyer-willing seller standard in valuing the holder's ownership interest for federal gift or estate tax purposes. Congress enacted Chapter 14 to the Code to attack the ability of high net worth individuals to shift current value in the business as well as future appreciation to the next generation(s) of the family in a family controlled enterprise without full transfer taxation by virtue of the retention of such discretionary rights. See §§ 2701(c)(1) (distribution right); 2701(c)(2) (liquidation rights). Section 2701 provides special rules in valuing certain rights retained in conjunction with the transfer to a family member of an interest in a family controlled corporation or partnership. These rules apply to any applicable retained interest held by the transferor or an applicable family member, as defined, immediately after the transfer of an interest in such entity. An applicable retained interest (ARI) is a liquidation, put, call, or conversion right, the exercise or non-exercise of which affects the fair market value of the transferred interest and a second species of ARI is a distribution right in a family controlled entity. A distribution right does not include any right with respect to a junior equity interest. The guiding valuation method applied under § 2701 is the "subtraction method" of valuation which as mentioned herein was rejected by the Tax Court in Estate of Newhouse v. Comm'r, 94 T.C. 193 (1990).

The legislative history to § 2701, contained in the Omnibus Budget Reconciliation Act of 1990, Pub. L. 101-508 (1990), the so-called anti-freeze (of value) provision, explains Congress' concern over preferred interest valuation freeze type transactions and the retention of discretionary payment rights by the senior family members:

> The committee is concerned about the potential transfer of wealth through the use of discretionary rights in a partnership or corporation. For example, wealth may pass from a preferred shareholder to a common shareholder if the corporation fails to pay dividends to the preferred shareholder. Even if the preferred stock is cumulative, such failure results in a transfer equal to the value of the use of the money until the dividend is paid. Or by exercising conversion, liquidation, put or call rights in other than an arm's-length fashion (or by not exercising such rights before they lapse), the transferor may transfer part or all of the value of such rights.
>
> Accordingly the committee adopts certain rules designed to eliminate the potential for transferring wealth through nonexercise of discretionary rights. The bill values at zero certain discretionary rights on the assumption that they will not be exercised in an arm's length manner. The bill also assures a full transfer tax from the failure to exercise cumulative distribution

rights in a timely fashion by compounding unpaid distributions.

The committee believes that the residual interest in a corporation or partnership may have value in excess of current projected cash flows because it carries with it the right to future appreciation. The market often gives substantial value to this "option value." Accordingly, the committee bill provides for a minimal value for the residual interests in a corporation or partnership. This minimum value, in effect, sets a floor on the discount rate used in valuing the preferred interests in a corporation or partnership that is not dramatically below the market rate. This floor reflects the minimal coverage that a purchaser of the preferred stock might require in the market for traded securities.

The Chapter 14 legislation also extended the statute of limitations on recapitalization as well as certain intrafamily transfers that were not reflected on a gift tax return which are determined by the Service to have an undisclosed transfer by gift element or component. See § 6501(c)(9). Under § 6501(c)(9), the Service may assess at any time any gift tax imposed by the Code on any gift of property the value of which is required to be shown in a gift tax return and which is not shown in such a return. However, this extended statute of limitations does not apply to an item disclosed on the return or in a statement attached to the gift tax return sufficient to apprise the Service of its nature. See Treas. Reg. § 301.6501(c)-1(f)(4) (disclosure requirement); Estate of Brown v. Comm'r, T.C.M. 2013-50. Compare, Estate of Redstone v. Comm'r, 145 T.C. 259 (2015).

Obviously, for recapitalizations of ownership interests that involve exchanges of equity interests which are outside the scope of § 2701 or fall within an applicable exception, the general valuation principles under the willing buyer, willing seller standard remain controlling. Therefore, the need for a thorough and carefully presented determination of value of the recapitalization of a family corporation or partnership in the form of a "fairness" opinion may be necessary in the view of legal and/or tax counsel for state law purposes, the "fairness" opinion may mean little to the Service and then a court in review to the extent that the recapitalization or gift of junior equity interests subject to the transferor's applicable retained interest in the company may take on secondary importance. Where § 2701 applies the "subtraction method of valuation" principle is required. Moreover, §§ 2704 and 2703 may further require that valuations be taken subject to certain assumptions or factors which would not necessarily apply to an unrelated willing buyer. This author and other commentators and practitioners have often referred to the Chapter 14 quartet of provisions as "artificial valuation" rules. See Stephens, Maxfield, Lind & Calfee, supra, ¶19.01 thru ¶19.04.

79 94 T.C. 193 (1990).

80 Again, note the prior discussion in footnote 77, supra, on Congress adoption of the residual or subtraction method of valuation in enacting § 2701.

81 Pub. L. 104-188, Title I, § 1702(f)(1); 136 Cong. Rec. § 15681 (12/18/1990) (interesting comment that the Senate Finance Committee made in the Congressional Report to § 2701 that states that the subtraction method of valuing corporate stock is based on present law principles regarding the valuation of residual interests). See discussion on § 2701 contained in footnote 77, supra.

82 Note that in many instances § 2701 will not apply in valuing closely held stock or partnership interests. The scope of the four valuation rules contained in §§ 2701-2704 and the case law decided thereunder of the 30-year period of enactment is beyond the scope of this article. See, e.g., Jerald David August, "Artificial Valuation of Closely Held Interests: Sec. 2704," 22 Est. Plan. 339 (1995); "Recent Decisions Frustrate Service's Efforts to Challenge Family Limited Partnerships," 27 Est. Plan. 403 (2000).

83 Treas. Reg. § 25.2701-2(b)(1) (see Treas. Reg. § 25.2701-2(b)(2) (extraordinary payment right); -2(b)(3) (distribution rights). See Treas. Reg. 25.2701-1(e), Ex. 2.

84 See §§ 2701(a)(1), 2701(d). Section 2704 was enacted to overrule the taxpayer favorable outcomes in Estate of Harrison v. Comm'r, T.C.M. 1987-8 (lapse of right to liquidation partnership not included in fair market value of converted general partner interest at death); Estate of Watts v. Comm'r, 1985-595, aff'd, 832 F.2d 483 (11 Cir. 1987) (restrictions precluding dissolution of partnership on partner's death not taken into account for valuation purposes). See Stephens Maxfield Lind & Calfee, supra, ¶19.02-¶19.04; Jerald David August, "Planning for Lapsing Rights and Restrictions—The Impact of Section 2704 on Valuation," 82 J. Tax'n 342 (1995).

85 But see the "white flag" that seems to have been raised by the Service on this issue. Rev. Rul. 93-12, 1993-1 CB 202 (1993), revoking Rev. Rul. 81-253, 1980-2 CB 2. See Estate of Bright v. U.S., 659 F.2d 999 (5th Cir. 1981); Propstra v. U.S., 680 F.2d 1248 (9th Cir. 1982); Estate of Andrews v. Comm'r, 79 T.C. 938 (1982); Estate of Lee v. Comm'r, 69 T.C. 860 (1978).

86 Treas. Regs. §§ 20.2031-2(a), 25.2512-2(a). Estate of Bright v. U.S., 658 F.2d 999 (5th Cir. 1981) (en banc); Estate of Andrews v. Comm'r, 79 T.C. 938 (1082). Lappo v. Comm'r, T.C.M. 2003-258. See Stephens Maxfield Lind & Calfee, supra, ¶¶ 4.02, 10.02.

This section of the article is not intended to provide the reader with a full view of the methods of valuation and potential discounts that may be claimed from normative value, only a survey of the main methods and discounts. There is ample case law in this area as well as many articles and publications both for lawyers as well as for other service providers, including the appraisal community and of course, experts who are asked to testify before the courts on the fair market value of closely held business interests.

87 Kosman v. Comm'r, T.C.M. 1996-112 (value of shares in private bank and bank holding company valued per market and income methods; discounts allowed for minority interest, lack of marketability, and lack of voting rights); Coleman v. Taub, 638 F.2d 628 (3rd Cir. 1981) ("freeze out" merger involving minority shareholders). See, in general, SJ Leacock, "Lack of Marketability and Minority Discounts in Valuing Close Corporation Stock," 7 Wm. & Mary Bus. L. Rev. 683; Charles W. Murdock, "Squeeze, Freeze-Outs and Discounts: Why Is Illinois In the Minority In Protecting

Shareholder Interests?" 35 Loy. U. Chi. L. J. (2004); Diana R. Ivanovic, "Nodak Bancorporation v. Clarke: Redefining the Rights of Minority Shareholders in a Freeze-out Merger under the National Bank Act," 39 Vill. L. Rev. 915 (1994).

88 Estate of Bright v. U.S., 658 F.2d 999 (5th Cir. 1981) (en banc) (decedents undivided community property ownership in 55 percent of the stock of a closely held corporation was to be valued at 27.5 percent interest and therefore would be valued as a minority interest. The Fifth Circuit state "we reject any family attribution to the estate's stock because established case law requires this result. Estate of Lee v. Comm'r, 69 T.C. 860 (1978) (community property interest of 80 percent of common stock and 100 percent of preferred stock valued as an undivided interest in half of the shares of each class thereby leaving estate a minority interest holder with respect to the common stock).

89 See, e.g., Estate of Litchfield v. Comm'r, T.C.M. 2009-21.

90 See Trust Services of America, Inc. v. U.S., 88-1 U.S.T.C. ¶13,767; Estate of Damon v. Comm'r, 59 T.C. 108 (1967), acq. 1968-2 CB 1; Estate of Wright v. Comm'r, T.C.M. 1997-53 (dismissed IRS argument that 23.8 percent interest constituted "effective control" under the facts including the super-majority voting requirements in the corporation's articles for fundamental event approval which IRS did not concede was adverse to its argument).

91 Should this premium take into account the fiduciary role or obligation of the owner to other owners or shareholders?

92 Treas. Regs. §§ 20.2031-2(f), 25.2512-2(f).

93 See, e.g., Estate of Newhouse v. Comm'r, supra; Phillip Morris, Inc. v. Comm'r, 96 T.C. 606 (1951), aff'd, 970 F.2d 897 (2nd Cir. 1992); Whittemore v. Fitzpatrick, 127 F. Supp. 710 (D.Conn.1954); Worthen v. U.S., 192 F. Supp. 727, 730-31 (D.Mass.1961); A. Hill, "The Sale of Controlling Shares," 70 Harv. L. Rev. 987 (1957). Compare Blanchard v. U.S., 291 F. Supp. 348 (S.D. Iowa 1968) (attributing a control premium to separate gifts of parts of a control block that would have been minority interests if valued separately while relying in part on testimony that the gifts would not have been sold outside of a control block) with Estate of Bright v. U.S., 619 F.2d 407, 409-411 (5th Cir. 1980).

94 See Estate of Rodriguez v. Comm'r, T.C.M. 1989-13. The Fifth Circuit has acknowledged that it is possible to find a minority interest could be valued by adding a premium for effective control. Rushton v. Comm'r, 498 F.2d (5th Cir. 1974). But see, Estate of Wright v. Comm'r, supra.

95 Estate of Simplot v. Comm'r, 112 T.C. 130 (1999), rev'd, 248 F.3d 1191 (9th Cir. 2001).

96 But see Estate of Winkler v. Comm'r, 1989-231.

97 See, e.g., Huber v. Comm'r, T.C.M. 2006-96 (50 percent); Estate of Lauder v. Comm'r, T.C.M. 1994-539 (40 percent); Okerlund v. U.S., 53 Fed. Cl. 341 (2002), aff'd, 365 F.3d 1044 (Fed. Cir. 2004) (40 percent); Estate of Piper v. Comm'r, 72 T.C. 1062 (35 percent); Wallace v. U.S., 566 F. Supp. 904 (D. Mass. 1981) (35 percent); Estate of Gallo v. Comm'r, T.C.M. 1985-394 (36 percent); Estate of Trenchard v. Comm'r, T.C.M. 1995-121 (40 percent).

98 Estate of Lauder v. Comm'r, T.C.M. 1992-736.

99 The Court stated that for federal estate tax purposes, buy-sell provisions setting a price for the purchase of stock in a closely held corporation will not be regarded as viable for valuation (and transfer tax) purposes under § 2043 and its application in lifetime gifts or bargain sale type cases where such agreement can be determined by the court as an artificial device to minimize taxes. See also § 2703.

100 See discussion of the lack of marketability discount factors in Mandelbaum v. Comm'r, T.C.M. 1995-255, aff'd, 91 F.3d 124 (3rd Cir. 1996). See also Mezzullo, Tax Management Portfolio, No. 831-4th, "Valuation of Corporate Stock," ¶VII Discounts and Premiums; Duncan, Jones, Jr., Spratt, Jr. "McCord to Holman—Five Years of Value Judgments," 34 ACTEC J. 254 (WESTLAW 2009). See also valuation rules under §§ 2701 (applicable retained interests), 2703 (buy-sell agreements and valuation)and 2704 (lapsing rights and ownership agreement restrictions) as well as under § 2032A (special use valuation). [AUGUST articles]

101 Pub. L. No. 9-514, § 631(a).

102 See AUGUST

103 General Utilities & Operating Co. v. Helvering, 295 U.S. 730 (1935).

104 See, e.g., Ward v. Comm'r, 87 T.C. 78 (1986); Estate of Piper v. Comm'r, 72 T.C. 1062 (1979); Estate of McTighe v. Comm'r, T.C.M. 1977-410; Gallun v. Comm'r, T.C.M. 1974-284; Estate of Thalheimer v. Comm'r, T.C.M. 1974-203, aff'd, and rem'd, 532 F.2d 751 (4th Cir. 1976), cert. denied, 429 U.S. 921 (1976); Estate of Cruikshank v. Comm'r, 9 T.C. 162 (1947). But see Obermer v. U.S., 238 F. Supp. 29 (D. Haw. 1964) (allowed discount for corporate level tax); Clark v. U.S., 1975 WL 610 (EDNC 1975).

105 The Service did not issue its concession on the issue of whether the discount was not "speculative." See TAM 9150001, AOD 1999-001(1/20/1999). The IRS Training for Appeals Officers Coursebook, however, acknowledges this factor at 9-13 (May 1997):

The taxpayer might take a deduction for prospective income tax liability, such as capital gains tax on unsold, but appreciated property, held by the corporation. This hidden discount might appear either in the calculation of the corporation's income stream or as a liability in the corporation's computation of adjusted book value. The case law has indicated prospective capital gains tax and liquidation expenses are speculative and not includible in the valuation. However, since the General Utilities doctrine has been revoked by statute (Tax Reform Act of 1986), a tax liability upon liquidation is not necessarily speculative.

106 155 F.3d 50 (2nd Cir. 1998), acq. 1999-4 IRB 4.

107 See §§ 11(a), 1231(a).

108 See cases cited in fn. .

109 Eisenberg v. Comm'r, 74 T.C.M. 1046, 1048-1049 (1997).

110 Estate of Davis v. Comm'r, 110 T.C. 530 (1998).

111 See, e.g., Estate of Welch v. Comm'r, 208 F.3d 213 (6th Cir. 2000) (unpublished).

112 Estate of Jelke v. Comm'r, 507 F.3d 1317 (11th Cir. 2007), cert. denied, 129 S. Ct. 168 (2008).

113 Estate of Jelke v. Comm'r, T.C.M. 2005-131, vacated and rem'd, 507 F.3d 1317 (11th Cir. 2007).

114 Estate of Dunn v. Comm'r, 301 F.3d 339 (5th Cir. 2002).

115 Estate of Jelke v. Comm'r, 507 F.3d at 1331.

116 See Jerald David August, "Proposed Regulations Under Section 199A: Qualifying for the 20 percent Business Deduction," 45 Corp. Tax'n 14 (Nov/Dec 2018).

117 Estate of Gross v. Comm'r, T.C.M. 1999-254.

118 272 F.2d 333 (6th Cir. 2001), cert. denied, 537 U.S. 827 (2002). See also, Wall v. Comm'r, 81 T.C.M. 1425; Estate of True v. Comm'r, T.C.M. 2001-167, aff'd on other grounds, 390 F.3d 1210 (10th Cir. 2004); Estate of Heck v. Comm'r, T.C.M. 2002-34. See Barr, "The Vexing Relationship Between Entity Form and Entity Value," 18 No. 1 Bus. Ent. 20 (WESTLAW).

119 Estate of Adams v. Comm'r, 83 T.C.M. 1421 (2002). See also, Estate of Giustina v. Comm'r, T.C.M. 2011-141, rev'd 586 F. App'x 417 (9th Cir. 2014), rem'd, T.C.M. 2016-114; Estate of Gallagher v. Comm'r, T.C.M. 2011-148, supplemented by T.C.M. 2011-244.

120 See also, Dallas v. Comm'r, T.C.M. 2006-212 (taxpayer did not meet its burden of proving that a hypothetical buyer and seller would "tax affect" S corporation's earnings and rejected expert testimony offered by the taxpayer on such contention).

121 See, e.g., Estate of Litchfield v. Comm'r, T.C.M. 2009-21 (17.4 percent discount from NAV); Estate of Jensen v. Comm'r, T.C.M. 2010-182 (100 percent discount from NAV allowed in valuing 82 percent interest in closely held C corporation); Estate of Richmond v. Comm'r, T.C.M. 2014-26 (Tax Court, subject to its Golsen rule of judicial administration to follow applicable precedent to the circuit court of appeals to which venue would lie, rejects the dollar-for-dollar corporate tax liability discount and will continue to follow the present value discount approach). See Robert E. Dallman, "The Built-in Gains Discount For Transfer Tax Purposes," 122 J. Tax'n 148.

122 Estate of Jones v. Comm'r, T.C.M. 2019-101.The deficiency in gift tax asserted by the government was for approximately $45 million.

123 Query, what would that appraiser think about § 6225(a)? See Jerald David August, "Tax Controversies and Litigation Under the New Centralized Partnership Audit Rules: Are You and Your Client's Ready?" Practical Tax Lawyer, March 2020 (Part 1) and May 2020 (Part 2).

124 The premium the petitioner's expert applied to the partnership's enterprise value for avoiding corporate income taxes was 22 percent, which it added to enterprise value. The same analysis was given for the shares of S stock. The same tax-affecting income valuation approach without any offsetting premium was also accepted in Kress v. U.S., 382 F. Supp. 3d 820 (E.D. Wis., 2019) in gift tax refund suit with respect to gifts of minority interest in stock in a family-owned S corporation to children and grandchildren. See, e.g., Estate of Adams v. Comm'r, T.C.M. 2002-80, Courtney Sparks White, "S Corporations: A Taxing Analysis of Proper Valuation," 37 Cap. U. L. Rev. 1117 (2009).

125 Martin Ice Cream Co. v. Comm'r, 110 T.C. 189 (1998); Norwalk v. Comm'r, T.C.M. 1998-279. But see Howard v. U.S., 446 Fed Appx. 752 (9th Cir. 2011).

126 See, e.g., Estate of Godley v. Comm'r, T.C.M. 2000-242, aff'd, 286 F.3d 210 (4th Cir. 2002) (valuation of decedent's interest in housing partnerships affected by HUD regulations, including rent subsidies); Estate of Gray v. Comm'r, T.C.M. 1993-334 (cross-ownership restrictions imposed by Federal Communications Commission negative factor in valuing communication company stock); Driver v. U.S., 38 A.F.T.R. 2d 73-6315, 6321 (W.D. Wis. 1973).

127 See, e.g., a federal district court's rejection of tax-affecting the value of a partnership interest under the discounted cash flow method based on expert testimony that it found sufficiently reliable. Hall v. Nettles, 2010 WL 11493794 (ND GA. 2010); Raby & Raby, "Tax Affecting—or Effecting—S Corporation Stock Valuations," 93 Tax Notes 1315 (2001) (inappropriate to tax affect earnings of S corporation assumed to continue as such). There are several decisions which courts applied a zero percent tax rate in valuing an ownership interest in a passthrough entity. Gross v. Comm'r, T.C.M. 199-254, aff'd, 272 F.3d 333 (6th Cir. 2001); Estate of Heck, T.C.M. 2002-34; Wall v. Comm'r, T.C.M. 2001-75; Estate of Adams v. Comm'r, T.C.M. 2002-80; Dallas v. Comm'r, T.CM. 2006-212.

128 See, e.g., Perracchio v. Comm'r, 86 T.C.M. 412 (2003). See generally, Stephens, Maxfield, Lind, Calfee & Smith, Federal Estate and Gift Taxation Ch. 19 (8th ed. 2003); see also Jerald David August & Guy B. Maxfield, "Where Are We Now with Family Limited Partnerships for Federal Tax Purposes?," 61st New York University Annual Institute on Federal Taxation (Nov/Dec, 2002); Jerald David August and Guy B. Maxfield, "Valuation of Interests 'In Transit' in Family Limited Partnerships," 5 No. 6 Bus. Ent. 20 (2003); Jerald David August, "Planning for Lapsing Rights and Restrictions-The Impact of Section 2704 on Valuation," 82 J. Tax'n (1995); Fife & Hosta, "Minimizing Application of Section 2704 in the Estate Tax Valuation of a General Partner's Family Limited Partnership Interests," 20 Tax Mgmt. Est., Gifts & Tr. J. 127 (1995).

129 See, e.g., Lappo v. Comm'r, T.C.M. 2003-258.

130 The Service has at various times argued that the formation of a limited partnership should not be respected for federal tax purposes as it lacked appropriate business purpose or that the formation of the partnership in fact resulted in taxable gifts to the extent membership interests were transferred to family members as part of the overall formation plan or arrangement. See Estate of Harrison v. Comm'r, T.C.M. 1987-8; Estate of Church v. U.S., 2001-1 ¶60,369 (WD Tex. 2000) (District court ruled that the family limited partnership had been legally formed before the death of the decedent, even though the certificate of limited partnership had not been filed until several days after death, and the formation of the sole corporate general partner had not occurred until six months later), aff'd, 268 F.3d 1063 (5th Cir. 2001).

131 See §§ 2704(a), 2704(b), 2701. Under § 2704(b), a restriction on the right of an owner to cause a liquidation of the entity or his interest in the entity is required, by law, to be disregarded as an "applicable restriction" in valuing

the interest transferred to a member of the transferor's family where the family has "control" over the entity and can either remove the restriction, or the restriction will lapse, after the transfer. Still, the law does allow a transfer restriction on liquidation or redemption to be taken into account for valuation purposes. However, a limitation on the right of an owner of an interest in an entity to cause the entity to be liquidated or to have his or her interest liquidated is taken into account if the limitation is no more restrictive than underlying state law (the so-called state law default provision) is not an applicable restriction if the limitation is no more restrictive than the state's default rule. § 2704(b)(3)(B); Treas. Reg. § 25.2704-2(b). See, e.g., Kerr v. Comm'r, 113 T.C. 449 (1999), aff'd, 292 F.3d 490 (5th Cir. 2002) (Tax Court held that partnership agreements providing for dissolution on specific date were no more restrictive than former Texas Revised Uniform Limited Partnership Act, § 8.01). The Fifth Circuit affirmed the Tax Court's decision but on different rationale which had to do with the fact that the waiver of the applicable restriction had to be approved by a non-family member limited partner, e.g., the University of Texas, and therefore the restriction was not an applicable restriction under § 2704(b)(2)(B). See also Estate of Harper v. Comm'r, T.C.M. 2000-202 (followed reasoning in Kerr, supra, to reject Service's contention that partnership agreement limitation on liquidation was an "applicable restriction" and should be ignored for transfer tax purposes); Estate of Knight v. Comm'r, 115 T.C. 506 (2000) (provisions of partnership agreement as to dissolution and withdrawal rights restrictions found no more restrictive than under state law and were not applicable restrictions for purposes of § 2704(b).

132 See § 2703.

133 See Estate of Jones v. Comm'r, 116 T.C. 121 (2001). Compare. Estate of Nowell v. Comm'r, T.C.M. 1999-15. For discussion, see Jack Bogdanski, "Partner vs. Mere Assignee—Is the Value Any Different?" 46 Est. Plan. 30 (Feb. 2019); Benjamin A. Cohen-Kurzrock, "Streightoff: Valuing Closely Held Entity Interests," 161 Tax Notes 947 (2018).

134 McCord v. Comm'r, 120 T.C. 358 (2003), rev'd and rem'd, Succession of McCord v. Comm'r, 461 F.3d 614 (5th Cir. 2006) (reversible error based on trial court's reliance on donees' post-gift agreement and donee's contingent obligation for additional estate taxes reduced taxable value of gift).

135 See Banoff & Lipton, "Gifts of Partnership Assignee Interests to Charity," Need cite—can' find.

136 Streightoff v. Comm'r, T.C.M. 2018-178.

137 As an aside, as assignee-only transfers, presumably he may have retained rights as the continued holder of the legal rights of the limited partner other than the right to receive distributions. The Service has treated the assignee of a partnership interest as the owner of the interest for federal income tax purposes.

138 Frank Lyon Co. v. U.S., 435 US 561 (1978). In the transfer tax area the substance over form doctrine was cited by Judge Kerrigan in the Streighthoff opinion in Heyen v. U.S., 945 F.2d 359 (10th Cir. 1991); Estate of Murphy v. Comm'r, T.C.M. 1990-427. The Court cited its earlier decision to the same effect in Astleford v. Comm'r, T.C.M. 2008-128.

139 Pub. L. No. 1010-239, § 7221. Prior to the 1989 legislation, the penalty provisions set forth in the Code frequently overlapped and could be result in multiple penalties or "stacking" of penalties. Congress consolidated the penalties into § 6662 to avoid the "stacking" problem. The revised provisions are contained in §§ 6662-6664. Congress has, from time to time, added to the list of penalties provided in the Code.

140 § 6662A imposes a 20 percent penalty on the portion of an underpayment attributable to a listed or reportable transaction. See also § 6707A. The penalty increases to 30 percent where the taxpayer fails to comply with the reportable transaction disclosure requirements under § 6664(d)(2)(A). The § 6662A penalty is not imposed with respect to that portion of an underpayment when the § 6663 fraud penalty is imposed. A discussion of the listed and reportable transaction rules is beyond the scope of this article.

141 This topic is also beyond the scope of this article. See Resiner v. Comm'r, T.C.M. 2014-230 (discusses elimination of the reasonable cause exception to gross valuation overstatement under the Pension Protection Act).

142 See §§ 6662(b)(1)-(b)(8).

143 See §§ 6851(termination assessment), 6861(jeopardy assessment).

144 In general, a "qualified amended return" is an amended return, or timely request for administrative adjustment under the partnership audit rules, § 6227, filed after the due date of the return for the particular year involved, including extensions, but before the taxpayer is contacted by the IRS about any audit or in other specific instances. See Treas. Reg. § 1.6664-2(c)(3).

145 Treas. Reg. § 1.6664-2(c).

146 There are ordering rules set forth in the regulations in computing the portion of an underpayment in tax subject to a penalty under § 6662 or § 6663.

147 Treas. Reg. § 1.6665-2(f). CARES Act, Pub. L. No. (NOL carryback for five years for taxable year beginning after 12/31/2017 and before 1/1/2021. See Rev. Proc. 2020-24, __ I.R.B. ___ (2020).

148 See e.g., Williams v. Comm'r, 114 T.C. 136 (2000).

149 See §§ 6665(a)(1) and 6665(b)(1) and 6651(b)(2).

150 § 6662(e)(2).

151 Treas. Reg. § 1.6662-5(a). The underpayment in tax required for the imposition of the accuracy-related penalty need not occur in the particular tax year where the misconduct occurs. A simple illustration would be a gross valuation misstatement of the adjusted basis of property in 2020 and the property generates cost recovery allowances in additional years in excess of the correct amount.

152 Under § 6701(a), an appraiser may be subject to a penalty of $1,000 where he is determined to have aided or assisted in the presentation or preparation of any portion of a return, affidavit, claim, or other document he knows or has reason to believe such portion will be used in connection with any material matter under the Code and knows that such portion if so used would result in an understatement of tax of another person. Where the return, affidavit, claim, etc. is of a corporation, the penalty amount is $10,000.

There are additional applicable rules in § 6701 as well as rules coordinating the § 6701 penalty with the tax return preparer penalties under § 6694 and the tax promoter penalty under § 6700. An appraiser who prepares an appraisal that results in a substantial or gross valuation misstatement may be subject to a penalty under § 6695A(b). The penalty is equal to the greater of $1,000 or 10 percent of the understatement in tax resulting from the substantial or gross valuation misstatement, up to a maximum of 125 percent of the gross income derived from the appraisal. This latter penalty does not apply if the appraiser can establish that it was "more likely than not" that the appraisal was correct. § 6695A(c).

153 § 6662(g), (h).

154 § 6601(e)(2)(B).

155 § 6662(h). See also §§ 6662A, 6700, 6701. The accuracy-related and additional promoter and abusive tax shelter penalties may overlap. See Fidelity Int'l Currency Advisor A Fund, LLC v. Comm'r, 661 F.3d 667 (1st Cir. 2011); Zfass v. Comm'r, 118 F.3d 184 (4th Cir. 1997); Merino v. Comm'r, 196 F.3d 147, 155 (3d Cir. 1999) ("whenever a taxpayer knowingly invests in a tax avoidance entity which the taxpayer should know has no economic substance, the valuation overstatement penalty is applied as a matter of course"); Illes v. Comm'r, 982 F.2d 163 (6th Cir. 1992); Gilman v. Comm'r, 933 F.2d 143, 151 (2d Cir. 1991) (penalty applied where tax shelter investment was a "sham" devoid of economic substance despite court's acknowledgement that applying the penalty in such instance may strain the literal reading of the term 'valuation overstatement'" where here "the lack of economic substance was due in part to the overvaluation, and thus the underpayment was attributable to the valuation overstatement"). Other decisions have following the construction given to the valuation overstatement in Gilman, supra. See Pasternak v. Comm'r, 990 F.2d 893 (6th Cir. 1993); Massengill v. Comm'r, 876 F.2d 616 (8th Cir. 1989); CMA Consol., Inc. v. Comm'r, 89 T.C.M. (CCH) 701 (2005); LKF X Invs., LLC v. Comm'r, 98 T.C.M. (CCH) 128 (2009); Jade Trading, LLC v. U.S., 80 Fed. Cl. 11, 50,112 (2007), aff'd, vacated, and rev'd in part sub nom. Ervi v. U.S., 598 F.3d 1372 (Fed. Cir. 2010); Santa Monica Pictures, LLC v. Comm'r, 89 T.C.M. (CCH) 1157 (2005) (taxpayer's claim of loss on disposition of asset held to have zero basis was valuation misstatement). See also Bergman v. Comm'r, 137 T.C. 136 (011), aff'd on other grounds, 2014-1 U.S.T.C. ¶50,136 (9th Cir. 2014).

156 Treas. Reg. § 1.6662-5(f)(1). For partnerships, the substantial or gross valuation misstatement is made at the entity level however the dollar limitation is applied at the partner level and aggregated with other underpayments on such taxpayer's return. Treas. Reg. § 1.6662-5(h)(2).

157 §§ 6662(g)(1), 6662(b)(5). See, e.g., Estate of True v. Comm'r, T.C.M. 2001-167, aff'd, 390 F.3d 1210 (10th Cir. 2004)(holdings in two separate business entities held by an estate were valued on the estate tax return and earlier gift tax return at less than 25 percent of the correct value resulting in penalty under § 6662(h); another business interest was valued at more than 25 percent of the correct value but less than 50 percent of the correct value resulting in a substantial gift tax valuation understatement under § 6662(g); court held that reasonable cause exception to the accuracy-related penalties did not apply since the record demonstrated that petitioners did not exercise ordinary business care and prudence as taxpayer decided to test the value under a book value purchase price provision contained in an applicable buy-sell agreement and did not engage a professional appraiser; decedent had the unilateral ability to change a buy-sell agreement while alive and accordingly cannot control the value for federal estate tax purposes); Estate of Blount v. Comm'r, T.C.M. 2004-116, aff'd, in part rev'd in part, 428 F.3d 1338 (11th Cir. 2005); Bommer Revocable Trust v. Comm'r, T.C.M. 1997-380. See David Berke, "Family Values: An Evaluation of Internal Revenue Code Section 2703 and 2704(b)," 41 ACTEC 197 (2016).

158 §§ 6662(h), 6662(h)(2)(C).See, e.g., Estate of Forbes v. Comm'r, T.C.M. 2001-72 (2001) (no penalty for estate valuation understatement because estate was properly valued); Estate of Giustina v. Comm'r, T.C.M. 2011-141 (2011) (holding no penalty for estate valuation understatement because reasonable cause exception applied due to taxpayer's reasonable reliance on expert valuation); Renier v. Comm'r, T.C.M. 2000-298 (2000) (holding no penalty for estate valuation understatement since resulting understatement did not exceed threshold amount of tax due). See § 6662(g)(2).

159 § 7491(c). Higbee v. Comm'r, 116 T.C. 438, 446 (2001); Raeber v. Comm'r, T.C. Mem 2011–39. In Graev v. Comm'r, 149 T.C. 23 (2017), supplementing 147 T.C. 460 (2016), the Tax Court held that in cases where the government bears the burden of production with respect to penalties under § 7491(c), the burden of production includes evidence of written supervisory approval of penalties as required by § 6751(b)(1). In Dynamo Holdings Limited Partnership v. Comm'r, the Tax Court held that the IRS does not bear the burden of production with respect to penalties under § 7491(c)(1) in a partnership-level audit proceeding. However, where the IRS does not bear the burden of production as to penalties, the lack of supervisory approval of penalties may be raised as a defense. NT, Inc. v. Comm'r, 126 T.C. 191 (2006); Chai v. Comm'r, 851 F.3d 190 (2nd Cir. 2017) (written approval must be obtained no later than the date the IRS issues the notice of deficiency (or files an answer or amended answer asserting such penalty). Compare. Graev v. Comm'r, 147 T.C. 460, 478 (2016) (§ 6751(b) does not require IRS internal approval until assessment, which does not occur until the Tax Court decision becomes final). See also, Sarvak v. Comm'r, T.C.M. 2018-68 (contains review of the intersection of § 7491(c) with § 6751(b)(1) and applicable case law cited in this footnote), See also, Nor-Cal Adjustors v. Comm'r, 503 F.2d 359 (9th Cir. 1974), aff'g T.C.M. 1971-200; Butler v. Comm'r, 114 T.C. 276, 286-287(2000).

160 See Chandler v. Comm'r, 142 T.C. 279 (2014); Kaufman v. Comm'r, 749 F.3d 56 (1st Cir. 2017), aff'g 143 T.C. 294 (IRS met burden of production at trial for imposition of accuracy-related penalties in disallowing deductions for charitable contribution of historic preservation façade easement in 2003 and 2004; taxpayers failed to make good faith investigation into value of easement in order to raise reasonable cause defense). As to underpayments resulting from easement overvaluations in claiming charitable

deductions, The Pension Protection Act of 2006 (PPA), Pub. L. No. 109–280, § 1219(a)(2)(B), amended the rules for the 40 percent gross valuation misstatement penalty. Before the PPA, the penalty applied when taxpayers misstated the value of their property by 400 percent or more. Taxpayers could avoid the penalty under certain circumstances if they made the misstatement in good faith and with reasonable cause. The PPA lowered the threshold to 150 percent for a substantial valuation misstatement and 200 percent for a gross valuation misstatement and eliminated the reasonable cause exception for gross valuation misstatements of charitable contribution property for all returns filed after July 25, 2006. §§ 6662(h), 6664(c). Where the correct value of an easement is determined to be zero, the value claimed by the taxpayer on the return is deemed to be 400 percent or more of the correct value and automatically results in a gross valuation misstatement. As to tax law trends and developments regarding the valuation of conservation easements in general, see Nancy McLaughlin, "Conservation Easements and the Valuation Conundrum," 19 Fla. Tax. Rev. 225. See also Blau v. Comm'r, 924 F.3d 1261 (CA-D.C., 2019), aff'g RERI Holdings I, LLC v. Comm'r, 149 T.C. 1 (2017). Curtis Investment Company LLC v. Comm'r, T.C.M. 2017-150 (gross valuation misstatement imposed with respect to disallowed deductions from custom adjustable rate debt structure, a/k/a "CARDS," loans based on lack of economic substance; partner-level defenses, including reasonable cause/good faith may not be asserted in TEFRA proceeding but may, as discussed in Judge Marvel's opinion for the Tax Court, be taken into account at the partnership level. Under the new partnership-level audit rules, partner-level defenses cannot be raised in determining the imputed underpayment amount of the partnership in accordance with § 6225.

161 HR Rep. No. 247, 101st Cong., 2d Sess. 1393 (1989). Prior to § 6664(c)(1), decisions in this area were decided on an abuse of discretion standard. See, e.g., Fisher v. Comm'r 45 F.3d 396 (10th Cir. 1995) (nonacq); McCoy Enter., Inc. v. Comm'r, 58 F.3d 557 (10th Cir. 1995); Vorsheck v. Comm'r 933 F.2d 757 (9th Cir. 1991) (court ordered waiver of substantial underpayment penalty against tax shelter investor who reasonably relied on advice of tax accountant); Owen's Estate v. Comm'r, 104 T.C. 498, 513 (1995) (abuse of discretion standard is whether "respondent exercised discretion arbitrarily, capriciously, or without sound basis in fact"); Shelton v. CIR, 105 T.C. 114 (1995) (IRS abused discretion by not waiving substantial understatement penalty where taxpayer reasonably relied on CPA's advice).

162 Treas. Reg. § 1.6664-4(b)(1). See, e.g., Estate of Thompson v. Comm'r, T.C.M. 2004-174 (estate qualified for § 6664 exception and, thus avoided gross valuation misstatement penalty on stock reported at value determined by attorney and accountant's appraisal based on various factors, including the unique nature of the assets that were undervalued, the government's experts' valuation errors, the aggressiveness of both parties in their positions, and the court's valuation of stock being closer to estate's valuation than to the IRS's), vacated and rem'd, 499 F.3d 129 (2d Cir. 2007) (further valuation and penalty computation proceedings), aff'd, 370 F. App'x 141 (2d Cir. 2010) (with regard to valuation misstatement penalty).

163 § 7491(c).

164 Tax Court Rule 142(a). See Klamath Strategic Inv. Fund et al v. U.S., 568 F.3d 537 (5t Cir. 2009) (reasonable cause established where trial court found that taxpayer properly relied on the legal advice from qualified accountants and tax lawyers on the legal implications of their investments and resulting tax deductions); Hoefle v. Comm'r, 114 F.2d 713 (5th Cir. 1940); Sabatini v. Comm'r, 98 F.2d 543 (2d Cir. 1938).

165 See, e.g., Montgomery v. Comm'r, 127 T.C. 43, 66 (2006); Swayze v U.S., 785 F.2d 715, 719 (9th Cir. 1985).

166 See Navaid v. Comm'r, 111 T.C.M. 1161 (2016) (reasonable cause not present under facts related tax consequences to liquidation of IRA); Stromme v. Comm'r 138 T.C. 213 (2012) (reasonable cause based on finding of taxpayer's "honest attempts to calculate their tax liabilities). Compare Roberts v. Comm'r, 141 T.C. 569 (20139).

167 Indeed the regulations specifically tell us that:

> Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances, including the experience, knowledge, and education of the taxpayer. An isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith. Reliance on an information return or on the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith. Similarly, reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect. Reliance on an information return, professional advice or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. Treas. Reg. § 1.6664-4(b)(1).

168 See Kaufman v. Comm'r, 784 F.3d 56, 69 (1st Cir. 2015), aff'd in part, rev'g in part 134 T.C. 182 (2011) (deduction for claimed value of façade easement disallowed; reliance on appraisal was not reasonable cause for excessive valuation; appraisers "assumptions and methodology were questionable at best, and the appraisal value was suspiciously high in view of facts and other evidence known or available to taxpayers); Estate of Thompson v. Comm'r, supra; Bergquist v. Comm'r, 131 T.C. 8, 23 (2008) ("to establish good faith, petitioners cannot blindly rely on advice from advisers, nor on an appraisal"); Kellahan v. Comm'r, T.C.M. 199-210; Estate of Goldman v. Comm'r, T.C.M. 1996-29. Compare Richmond's Est. v. Comm'r, 107 T.C.M. (CCH) 1135 (2014) (reasonable cause not established as, in large part, estate failed to obtain appraisal of stock in family holding company).

169 Kaufman v. Comm'r, 784 F.3d 56 (1st Cir. 2015).

170 Kaufman v. Comm'r, 107 T.C.M. 1262 (2014).

171 § 6751(b)(1) provides, in general, that no penalty may be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate

supervisor of the individual making such determination or such higher-level official as the Secretary may designate. Certain exceptions apply. See, e.g., Grace Foundation v. Comm'r, T.C.M. 2014-229; Chai v. Comm'r, 851 F.3d 190 (2nd Cir. 2017).

172 Other decisions weigh in on the reasonable cause defense where there are valuation misstatements. Estate of Berg v. Comm'r, 976 F.2d 1163 (8th Cir. 1992), aff'd in part, rev'd in part, T.C.M. 1991-279 (valuation misstatement; reliance on CPA tax advisor and professional appraiser constituted reasonable cause); Estate of Richmond v. Comm'r, T.C.M. 2014-26 (§ 6662(b)(5) accuracy-related penalty imposed on substantial understatement of value of closely held stock; estate used unsigned draft report prepared by accountant who was not certified appraiser and estate did not explain how accountant arrived at his valuation or why estate proferred another expert's higher valuation at trial; in determining that IRS had satisfied its burden for imposing penalty, court noted that value originally reported on return was, under § 6662(g) standard, not only 65 percent or less of value court determined to be correct but also 65 percent or less of value as estate's expert contended at trial).