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Barney v. Commissioner

Tax Court offers insights into qualified appraisal requirements

The U.S. Tax Court's decision in *Barney v. Commissioner* underscores the importance of substantiating charitable deductions of property valued above $5,000 with a "qualified appraisal." Although the ruling arose from a motion for summary judgment, it provides valuable insights into how the Tax Court determines whether an appraisal "substantially complies" with the qualified appraisal requirements.

Case facts

The petitioner, through his living trust, owned 100% of the stock of five S corporations. Four of the corporations operated for-profit career colleges and the other provided management services for those colleges. In 2006, the petitioner's state established the Center for Excellence in Higher Education (CEHE) as a nonprofit public benefit corporation. The IRS recognized CEHE as a tax-exempt 501(c)(3) organization in 2007.

In 2011, the petitioner and CEHE began discussing a potential merger between CEHE and the S corporations. In December 2012, the petitioner obtained a valuation report for the five entities and executed the merger.

Under the merger agreements, three of the corporations were sold to CEHE. The two remaining entities were transferred gratuitously to CEHE as charitable contributions. In addition, CEHE issued two promissory notes, totaling $431 million, to the petitioner's trust. These notes required CEHE to pay a portion of its income from operating the colleges to the petitioner and imposed restrictions on CEHE's use or sale of the colleges.

On their tax returns, the two donated S corporations reported charitable contributions based on their fair market values. The other three corporations reported charitable contributions based on the excess of their fair market values over the purchase price.

IRS challenge

The IRS challenged the charitable deductions, ultimately bringing the matter before the Tax Court. The IRS moved for summary judgment, arguing that the petitioner failed to substantiate the deductions with a qualified appraisal as required by federal income tax regulations. (See "Key elements of a qualified appraisal report" at page 3.)

Specifically, the IRS pointed to the appraisal report's failure to address how promissory note restrictions affected the corporations' values. A qualified appraisal must include "the terms of any agreement or understanding entered into … by or on behalf of the donor or donee that relates to the use, sale, or other disposition of the property."

Not only did the valuation fail to address the notes' terms, but it expressly stated that

Key elements of a qualified appraisal report

Among other requirements, qualified appraisals of donated property for charitable deduction purposes must be conducted by a "qualified appraiser" and completed near the time of a contribution. Additionally, qualified appraisals require a thorough appraisal report that includes:

- A detailed description of the property,
- The physical condition of the property, if applicable,
- The dates of the contribution and valuation,
- Terms of any agreement or understanding relating to the use, sale or other disposition of the property,
- The appraiser's qualifications,
- A statement that the appraisal was prepared for income tax purposes, and
- A description of methods used to determine fair market value and the specific basis for the valuation (for example, comparable sales or statistical sampling).

"there are [no] agreements or understandings entered into that must be disclosed as required under [the substantiation requirements for charitable deductions under Internal Revenue Code Section 170]." The petitioner countered that the IRS used an "overly technical" interpretation of the Sec. 170 requirements. He further claimed the regulations only required "substantial compliance," and the promissory notes' effects on value were a matter of fact for trial.

Motion denied

The court denied the IRS's motion for summary judgment, leaving for trial whether the appraisal substantially complied with the Sec. 170 requirements. However, the court's discussion of these requirements is instructive. The court emphasized that literal compliance with qualified appraisal requirements isn't necessary — *substantial* compliance is enough. Under that standard, an appraisal substantially complies if it discloses sufficient information for the IRS to evaluate its reliability and accuracy.

The court went on to explain that a taxpayer can demonstrate substantial compliance by providing "most of the information required" or by showing that any omissions were inadvertent. However, these comments don't bode well for the petitioner's claim that it substantially complied with the regulations. Specifically, though substantial compliance allows minor or technical defects, the opinion says that taxpayers must disclose information related to the governing statute's essential requirements. The court further explained that an appraisal won't pass muster if it:

1. Fails to meet substantive requirements in the regulations, or

2. Omits entire categories of required information.

Examples include the appraisal date, the name or credentials of the appraiser, and the property's fair market value.

Valuable lesson

Barney serves as a valuable reminder that failure to meet the qualified appraisal requirements can put millions of dollars in charitable deductions at risk. It's not certain whether the petitioner will ultimately persuade the court at trial that it substantially complied with the requirement. However, the decision highlights the importance of addressing and disclosing all material facts — including any restrictions on the use, sale or other disposition of donated property. ■

Developing discount rates in today's economy

Under the income approach, value is a function of two metrics: returns and risk. Business valuation professionals measure *returns* with future income streams and the *risk* of achieving those returns with discount rates. Estimating discount rates is a complex task, even in the best of times. Uncertainty about economic conditions may affect the rates of return that valuators use in their financial models. Let's take a closer look.

How are discount rates measured?

Depending on the situation, valuators use two kinds of discount rates to value a business. The first — referred to as the cost of *equity* — is applied to earnings (typically, net cash flows) available to equity investors. The second discount rate — referred to as the cost of *capital* — is applied to earnings available to *both* equity and debt investors. The cost of capital is a blend of the cost of debt and the cost of equity, usually weighted according to their relative percentages of total capital. The cost of debt is generally based on the company's actual borrowing costs.

When estimating the cost of equity, a common starting point is a "risk-free" rate, such as long-term yields on U.S. Treasury bonds. Then the valuator adds amounts to capture the additional risk associated with an investment in the subject company. For instance, the build-up method starts with a risk-free rate and factors in the following components:

- An equity risk premium to reflect the additional risk inherent in equity investments,
- A size premium to reflect the heightened risk associated with smaller companies, and
- A company-specific risk premium to reflect risk factors specific to the subject business.

An industry-specific risk premium may be appropriate in some circumstances. A higher discount rate equates with higher risk and, therefore, a lower business value.

How do economic conditions affect discount rates?

Think of business value as a moving target. A value conclusion is valid as of a specific point in time. Internal and external factors that affect a company's value — including economic conditions — may change. Valuators must put themselves in the shoes of hypothetical buyers and sellers and consider only what was "known or knowable" on the valuation date.

When estimating the cost of capital, valuators evaluate economic conditions that existed on the valuation date. In today's volatile markets, perceived risks may change quickly. Examples of current risk factors that may affect the cost of capital are tariffs, geopolitical threats, inflation, monetary policy, government spending and tax law changes. The degree to which these

factors are relevant may depend on the company's industry and management's responses to evolving market conditions.

It may be possible to reduce, or even offset, the impact of market volatility on business value by demonstrating improvements in a company's fundamentals. For instance, a company might switch to more cost-effective suppliers, pivot to new markets, introduce new products or cut costs. These adaptations could effectively lower the company-specific risk premium in a build-up model for the cost of equity. Likewise, modifying the company's capital structure to rely more on debt financing may potentially lower the cost of capital.

How do valuators avoid double-counting?

Valuators carefully weave the effects of economic uncertainty into their analyses to avoid double-counting risk factors. Risks may be factored into discount rates (such as the risk-free rate, equity risk premium and company-specific risk). Or they might be accounted for elsewhere in the valuator's analyses (such as when these experts quantify projected returns and marketability discounts). Counting the same risk factors in multiple components of a valuation model can lead to an inaccurate conclusion.

> When estimating the cost of capital, valuators evaluate economic conditions that existed on the valuation date.

Another critical element is assessing whether the discount rate results appear reasonable. That is, the valuator must evaluate whether the rate reflects an accurate return that an investor would require based on the risk associated with a particular investment.

Experience counts

When estimating discount rates in an uncertain economy, one thing is certain: You need an experienced, full-time valuation professional who's on top of the latest research, trends and professional developments. Outdated cookie-cutter approaches won't cut it in today's economic environment. ■

What are the federal boundaries for lost profits evidence?

The U.S. District Court for the Middle District of Louisiana in *North Atlantic Security Co. v. Blache* recently examined the admissibility of exhibits and testimony offered to prove lost profits damages. The court excluded a document that summarized the plaintiff's alleged damages because it wasn't supported by the "voluminous" underlying data. Testimony from the plaintiff's current and former presidents was deemed admissible. But, after reviewing their proposed testimony, the court expressed skepticism about the plaintiff's ability to prove damages.

Plaintiff's license revoked

The plaintiff, a licensed provider of security services in Louisiana, was awarded a contract to provide security services to several state agencies. Less than a year later, the defendant, the executive secretary of the state's Board of Private Security Examiners, accused the plaintiff of violating certain state regulations. The defendant subsequently revoked the plaintiff's license without a board hearing or vote. Then he notified the state, which terminated the plaintiff's contract.

The plaintiff sued the defendant on several grounds. One significant lost profits claim was against the defendant in his individual capacity for violating the plaintiff's due process rights. The issue before the court was the admissibility of certain documents and testimony. This included an "itemization of losses" and the testimony of the plaintiff's current and former presidents regarding lost profits.

Court excludes itemization of losses

The plaintiff submitted into evidence a spreadsheet that itemized various financial metrics, including the company's revenue and expenses, net income, and projected revenues from 2018 to 2024. The defendant sought to exclude the itemization as unreliable and speculative, arguing that the numbers didn't add up. He also challenged it as an improper summary exhibit.

> An injured party's testimony alone, unsubstantiated by other evidence, is insufficient to establish lost profits with reasonable certainty.

The court determined that the plaintiff failed to provide the defendant with data underlying the spreadsheet, as required by Federal Rules of Evidence 1006. So, it excluded the itemization as an improper summary exhibit.

Court opines on officer testimony

The court allowed the testimony of the plaintiff's current and former presidents because they had personal knowledge of the information in the itemization spreadsheet. However, the court expressed skepticism about its sufficiency to prove damages. For one thing, an injured party's testimony alone, unsubstantiated by other evidence, is insufficient to establish lost profits with reasonable certainty.

In addition to lost profits stemming from the contract itself, the plaintiff sought profits it allegedly would have derived from "collateral undertakings." In essence, the plaintiff claimed, if not for the defendant's wrongdoing, the Louisiana contract would have served as a "springboard" for additional work.

However, to recover such damages, plaintiffs must prove that:

- The defendant's actions proximately caused the plaintiff to lose business,
- Losses were foreseeable, and
- Losses could be estimated with reasonable certainty, without relying solely on testimony.

In *North Atlantic Security*, the court observed, "This is a high hill and the Court is skeptical of [the plaintiff's] ability to climb it." Nevertheless, the court allowed the presidents to testify, explaining that, at that stage, it could not conclude that their testimony would be "inadmissible for any purpose."

Seek outside expertise

This case illustrates that establishing lost profits with reasonable certainty is challenging, particularly when calculations are based on consequential damages. Although it's possible for lay witnesses to testify on this subject, it's critical to back up testimony with solid evidence. Estimating lost profits isn't a do-it-yourself project. To bolster claims, consider hiring a qualified financial expert to independently calculate lost profits and evaluate the underlying financial data. ■

Dodge buy-sell agreement pitfalls with detailed valuation provisions

Private business owners enter into buy-sell agreements for various reasons. Some hope to avert lawsuits if owner relations suddenly sour. Others want to be able to expedite liquidation if they decide to leave the company. And some owners simply need to ensure their heirs will someday receive a fair price for the business.

Unfortunately, these agreements can fall short when they gloss over valuation issues. Here are three common traps and some practical fixes.

1. Unclear valuation standard

A buy-sell agreement should specify the "standard of value" to apply to the departing owner's interest. Many agreements default to the fair market value standard under IRS Revenue Ruling 59-60, without fully understanding the precise meaning. Owners of noncontrolling interests may be surprised when their buyout prices under this standard include discounts for lack of marketability and control.

The owners may intend for a noncontrolling owner to receive his or her pro rata share of the *entire* company's value. In that case, the agreement should specify a different valuation standard (for example, fair value). Or it might explicitly address whether discounts apply.

2. Unstructured valuation process

A buy-sell should outline *how* the buyout price will be determined. For instance, it may initially allow the parties to privately negotiate an acceptable buyout. If negotiations fail, the agreement may call for a predefined buyout formula. But a formula can backfire if it's oversimplified or outdated.

Alternatively, a buy-sell may require the parties to hire one or more outside valuation experts to assess the interest's current value. Here, it's important to clarify who will pay for the valuation(s) and, if multiple valuations are conducted, how the final price will be selected.

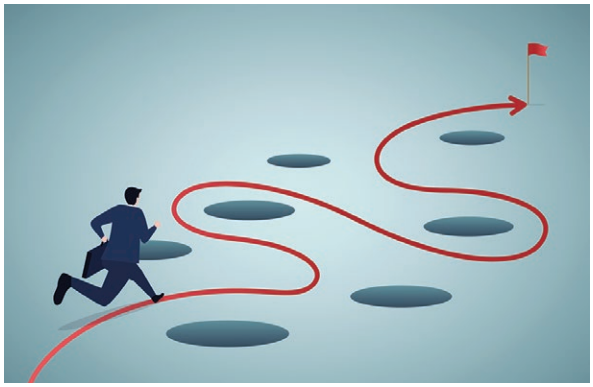
3. Unspecified terms and funding

Who's responsible for buying the departing owner's interest — the company or individual owners? Many agreements adopt a "wait and see" approach that allows the parties flexibility. Others may incorporate a right-of-first-refusal clause for the remaining owners or preclude transfers to undesirable or unrelated parties.

To avoid disputes, the parties should iron out payment terms and financing sources upfront. For instance, lump-sum payments allow the company and the departing owner to quickly sever ties. Conversely, installment payments may offer tax advantages for departing owners and ease liquidity pressures for buyers.

Get it right

Buy-sell agreements are often triggered during stressful conditions — amid unexpected deaths, strained resources and leadership transitions. An agreement that covers all the valuation bases can provide assurance, clarify buyout issues and diffuse tensions between owners. Working with a valuation pro when preparing and updating a buy-sell agreement can increase the odds it'll succeed. ■



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- Domestic Relations Matters
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- Criminal Tax Matters
- Valuing Closely Held Businesses
- Purchase or Sale of Business
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