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**Business Valuation Breakout Session  
Tax Case Law Update 2:00 P.M. to 3:00 P.M.**

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Session Objective

This session will provide an overview of recent business valuation cases filed by the United States Tax Court and the United States Federal Courts, as well as offer observations about trends in these court opinions. This session will also address effective practices related to the attorney – appraiser relationship.

Learning Objectives

Participants will be provided with a summary of recent court opinions involving the valuation of privately held business interests for federal tax purposes. Specific emphasis will be devoted to major business valuation issues that the United States Tax Court and the United States Federal Courts have addressed in recent opinions including lack of marketability, built-in capital gains, among other issues. Additional emphasis will be devoted to the practical considerations of integrating the implications of recent opinions into the appraiser's valuation practice.

## AUTHORS/LECTURERS

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Mr. Bronza is a frequent speaker on the topic of business valuation. He has lectured before the American Bar Association Section of Taxation Estate and Gift Taxes/Fiduciary Income Tax Committee, the Florida Bar Business Law Section, the Florida Bar Tax Section, the Florida Bar Real Property, Probate and Trust Law Section, the Florida Institute of Certified Public Accountants (FICPA), several estate planning councils and numerous other organizations. He has also prepared conference materials for the Southern Federal Tax Institute.

Mr. Bronza has also authored articles on valuation published in various regional and national publications including the *Florida Bar Journal*, *West Group's Estate and Personal Financial Planning* and *Valuation Strategies*. He has also been quoted in *Lawyer's Weekly USA* and *Leimberg Information Services Estate Planning Email Newsletter*.

Mr. Bronza currently serves as treasurer of the Central Florida Estate Planning Council and is a former board member Tampa Bay Estate Planning Council. He also serves on the Board of Advisors of the Stetson University Family Enterprise Center and is the current chair and a charter board member of the Professional Advisors Network of the Community Foundation of Central Florida.

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## **I. SELECTED VALUATION OPINIONS**

### **A. Validity/Inclusion Cases**

#### *1. Estate of Miller v. Commissioner, T.C. Memo 2009-119, Filed May 27, 2009*

The Miller opinion dealt with two issues for decision, whether a QTIP trust was to be included as a part of the gross estate, and whether discounts were applicable for contributions to the Miller Family Limited Partnership (MFLP) as of May 2002 and May 2003. With respect to the QTIP issue, the Tax Court reviewed the facts and law and determined that the QTIP was to be included in the gross estate because the QTIP assets were available to the estate, whether or not the assets were needed by the decedent, as was claimed by the estate. The Court's opinion on the valuation discounts was a split decision, affirming the discounts for the May 2002 transfers and disallowing the application of discounts for the May 2003 transfers.

Virgil G. Miller, the predeceased spouse of the decedent, Valeria Miller, spent 26 years managing his securities portfolio using a method of charting stocks that he personally developed. In the years prior to his death, Mr. Miller spent considerable time with his son Virgil in managing the family's securities. When Mr. Miller died in 2000, the value of the securities in the portfolio had grown to approximately \$7 million.

After Mr. Miller died, Valeria Miller formed the MFLP. At the time MFLP was formed, Mrs. Miller was 86 years old and in good health. The partnership agreement was executed on March 6, 2002, and the MFLP was subsequently funded in May 2002 with some of the family's securities being held by the MFLP. Upon formation, 1,000 partnership units were issued and outstanding. Mrs. Miller held 920 limited partnership units, and the remaining 80 units were split equally between her four children. Of these 80 units, Virgil Miller held 10 general partnership units and 10 limited partnership units, and each of his three siblings held 20 limited partnership units. After formation, Virgil Miller continued to actively manage the securities portfolio held by MFLP, spending as much as 40 hours per week in doing so.

Just prior to her death on May 28, 2003, Mrs. Miller transferred the bulk of her remaining securities to the MFLP. At the time the securities were transferred, Mrs. Miller had broken her hip but had not developed the health problems that led to her death.

The Estate filed a timely 706 claiming discounts of 35% for lack of marketability attributable to the limited partnership units held by the Estate that were a consequence of transfers of securities to the MFLP in 2002 and 2003. The IRS issued a notice of deficiency of approximately \$1 million.

At trial, the Estate argued that the transfers to the MFLP met the requirements under §2036(a) and its bona fide sale exception, that the securities transferred to the MFLP were not commingled with the decedent's personal assets, and all partnership formalities were followed. In contrast, the IRS alleged that the transfers were not bona fide sales, supporting its contention with a

number of arguments, including: 1) the MFLP was not an active business, 2) the decedent's age, 3) the decedent's failure to retain sufficient assets outside the MFLP, among other factors.

In its opinion, the Tax Court held that the 2002 transfers to the MFLP constituted valid partnership, formed for legitimate and nontax business purposes. In its opinion, the Court cited that the "MFLP involved an active securities trading operation closely aligned with Mr. Miller's investment strategy. Decedent wanted her assets to be traded according to her husband's investment philosophy and set up MFLP to do just that."

In its disallowance of the 2003 transfers to MFLP, and the discounts related to the 2003 transfers asserted by the Estate, the Court found that there were "driving forces" behind these transfers, and the transfers were a tax avoidance device with "no significant nontax purpose."

**COMMENT:**

The due diligence performed by a business appraiser can prove critical to the substantiation of the operation of an investment holding entity such as MFLP. Although it appears that the evidence related to MFLP was introduced independent of the valuation in this court opinion, business appraisers should be mindful that when valuing an investment holding entity and conducting related due diligence, such items as investment policy and strategy, as well as the duties performed by principals of the entity being valued, should be considered and discussed in text of the appraisal.

2. Estate of Jorgensen v. Commissioner, T.C. Memo 2009-66, Filed March 26, 2009

The primary issue of this Tax Court opinion involves whether the value of assets transferred to two family partnerships are to be included in the decedent's gross estate under §2036(a).

The decedent and her husband, an army colonel, formed a family limited partnership in 1995 that was funded with approximately \$500,000 in marketable securities. With respect to the investment management of the marketable securities, the principals of the partnership adhered to the same "buy and hold" philosophy that was employed as an investment strategy prior to the partnership's formation. At the time the colonel passed away in 1996, the widow's estate planning attorney recommended that the widow contribute additional securities to the partnership as well as form a second FLP. The widow implemented both recommendations. As a means to incentivize his client to act on his recommendation, the widow's attorney suggested that "hopefully your limited partnership interest ... will qualify for the 35% discount."

From 1996 through 2002, both partnerships held passive investments only and neither partnership was involved in the operation of an active business. In addition, the widow withdrew partnership funds to make cash gifts to family members, and pay taxes and personal expenses, even though in her capacity as a limited partner the widow did not have the legal capacity to make such withdrawals. The widow also made annual exclusion gifts of limited partnership interests from 1999 to 2002. Subsequent to the decedent's death and filing of the estate tax return, the IRS issued a notice of deficiency claiming that the assets transferred to each partnership were transfers that were made in her lifetime in which she had retained interests.

The estate argued that the transfers of assets to the partnerships met the provision of §2036(a) that accepts any transfer of property otherwise subject to that section which is a "bona fide sale for an adequate and full consideration in money or money's worth." In its defense, the estate claimed it met the exception provision through each of the following purposes, 1) management succession, 2) financial education and family unity, 3) perpetuation of investment philosophy, 4) pooling of assets, 5) spendthrift concerns, and 6) to facilitate gifts. None of these arguments were embraced by the Tax Court as legitimate or significant nontax reasons for the establishment of a partnership.

The Court ruled that the assets of the FLPs were to be included in the decedent's gross estate as a consequence of §2036(a)(1). In its finding the Court stated, "We find especially significant that the transactions were not at arm's length and the partnerships held a largely untraded portfolio of marketable securities."

**COMMENT:**

This is another in a series of "bad facts" family partnership cases that highlights the importance of respecting the formalities of the partnership and having adequate documentation for the nontax purposes of the partnership.

3. Estate of Hurford v. Commissioner, T.C. Memo 2008-278, Filed December 11, 2008

Mr. Hurford died in 1999, leaving an estate of over \$14.2 million. Subsequent to Mr. Hurford's death, an estate planning attorney hired by the Hurford family created three FLPs, one each for the real estate, marketable securities, and phantom stock assets in Mr. Hurford's estates. Unfortunately for the Hurford family, the attorney was "sloppy" in drafting the governance agreements and managing the administration of the partnership. Importantly, he failed to get current, independent appraisals for assets that funded the FLPs.

Thelma Hurford died within two years of Mr. Hurford. From the time the FLPs were established to her death, her limited partnership interests were sold to her children in exchange for a private annuity. The assets reported on the estate tax return amounted to \$846,666. Subsequent to the filing of the return, the IRS issued two notices of deficiency, one for the estate tax return of \$9,805,082 plus \$1,956,066 in penalties; and the second related to the 2000 gift tax return for \$8,314,283 plus \$1,662,857 in penalties. The primary issue for consideration at trial was what assets should be pulled back into the estate, specifically, whether the initial transfer of assets to the FLPs and subsequent private annuity transactions were valid under IRC §2035, 2036 and 2038.

While admitting the sloppiness of the attorney, the estate contended that the decedent's tax returns were correct. The IRS claimed that the plan was "nothing more than a transparently thin substitute for a will" and that decedent effectively kept control over all the assets.

The Court concluded that the decedent's transfer of property to the FLPs and the private annuity transaction were void for lack of fair and adequate consideration. In its conclusion, the Court cited a number of factors including that the decedent commingled personal and partnership funds, the attorney disregarded partnership formalities in forming and funding the partnership, and egregious errors were made on the decedent's tax returns. In its analysis of reasons for creating the FLPs it dismissed any legitimate reason stating that, "This leaves only the Hurfords' drive for a discount as a reason for creating the FLPs."

**COMMENT:**

Unfortunately for the taxpayer, the concept of garbage in, garbage out, seemed to be the scenario that influenced the Court in this opinion. The bad facts of not respecting the partnership formalities and sloppy work by legal counsel resulted in an unfavorable outcome for the taxpayer.

4. *Estate of Mirowski v. Commissioner, T.C. Memo 2008-74, Filed March 26, 2008*

On August 22, 2001, Anna Mirowski executed the pertinent documents to form limited liability company (Mirowski Family Ventures or “MFV) and these documents were subsequently filed on August 30<sup>th</sup>. At the time of formation, Ms. Mirowski, a diabetic, suffered from a foot ulcer, but the condition did not endanger her life.

The Court’s finding of facts related to the purpose of forming MFV stated, “Although Ms. Mirowski understood that certain tax benefits could result from forming MFV, those potential tax benefits were not the most significant factor in her decision to form MFV. To the contrary, Ms. Mirowski had the following legitimate and significant nontax purposes for forming and transferring the bulk of her assets to MFV: (1) joint management of the family’s assets by her daughters and eventually her grandchildren; (2) maintenance of the bulk of the family’s assets in a single pool of assets in order to allow for investment opportunities that would not be available if Ms. Mirowski were to make a separate gift of a portion of her assets to each of her daughters or to each of her daughters’ trusts; and (3) providing for each of her daughters and eventually each of her grandchildren on an equal basis.”

On September 1<sup>st</sup> and 7<sup>th</sup> she contributed \$60 million in assets including patent and licensing agreements that were developed by her predeceased husband. She transferred a 16% membership interest to each of her three daughters on September 7<sup>th</sup>, for total transfers of 48%. On September 10, 2001 she developed a severe blood infection related to her foot ulcer, and on September 11, 2001 she died.

In its ruling the Court stated that MFV was “valid functioning operation and has been managing the business matters related to the ICD patents and .... license agreements, including litigation. In making this determination the Court also ruled that because the §2036(a) bona fide sale exception applied, the valuation discounts asserted by the taxpayer were deemed valid. The Court also found that given the provisions in the operating agreement that imposed fiduciary obligations, there was no implied agreement of retained income or enjoyment of assets transferred to MFV, thus the gifts were held to be valid.

**COMMENT:**

Although the IRS argued the common “deathbed” entity issues, the taxpayer was able to overcome these arguments due to the valid business purpose for MFV, the preparation of meticulous governance documents by legal counsel, and by respecting entity formalities. Although the *Mirowski* opinion is silent with respect to the details of the appraisals, to the extent the appraisals were prepared in a manner consistent with the preparation of the governance documents and the operation of the limited liability company, it is likely they contributed to the favorable outcome of this case for the taxpayer.

## B. Pure Valuation Issues

### *1. Estate of Litchfield v. Commissioner, T.C. Memo 2009-21, Filed January 29, 2009*

The IRS determined a deficiency of approximately \$6 million related to the valuation of minority interests in two privately held investment entities for estate tax purposes as of April 17, 2001. The IRS and the estate agreed as to the net asset values of the respective entities, however, they differed on discounts for built-in capital gains, lack of control, and lack of marketability.

The first entity, Litchfield Realty Co. (“LRC”), held Iowa farmland, marketable securities and a subsidiary corporation that owned and operated a public grain elevator, sold crop insurance and provided farming related services. LRC had converted from a C corporation to an S corporation in January 2000, therefore, to the extent LRC sold any of its assets acquired when it was a C corporation, the corporation would be subject to §1374 corporate level tax on the sale. As of the valuation date, LRC’s total net asset value of \$33.174 million included \$28.762 million in built-in capital gains, or approximately 87% of net asset value.

In connection with the federal estate tax return, the estate’s expert appraised the 43.1% interest in question at \$6.475 million. This value conclusion was inclusive of discounts for built-in capital gains, lack of control and lack of marketability. In contrast, in its audit of the estate tax return, the IRS valued the 43.1% interest held by the Estate at approximately \$1.0 million and assessed a deficiency of \$3.825 million. The following table summarizes the respective valuation positions of the estate and IRS:

	<b>Estate</b>	<b>IRS</b>
Net asset value	\$14.298 million	\$14.298 million
Discount for built-in capital gains	17.4%	2.0%
Discount for lack of control	14.8%	10.0%
Discount for lack of marketability	36.0%	18.0%
Opinion of fair market value	\$6.475 million	\$10.069 million

The estate also held a second interest, a 23% interest in a C corporation, Litchfield Securities Co. (“LSC”). LSC held marketable securities and other equity investments and had a combined net asset value of \$52.824 million. LSC’s investment strategy focused on maximizing cash dividends to shareholders. As of the valuation date, the net asset value of LSC included \$38.984 million in built-in capital gains, approximately 73.8% of its total net asset value. The following table summarizes the respective positions of the estate and the IRS for the value of LSC:

	<b>Estate</b>	<b>IRS</b>
Net asset value	\$12.133 million	\$12.133 million
Discount for built-in capital gains	23.6%	8.0%
Discount for lack of control	11.9%	5.0%
Discount for lack of marketability	29.7%	10.0%
Opinion of fair market value	\$5.748 million	\$9.565 million

The Court first considered the respective discounts for built-in capital gains. The estate's expert reviewed asset sales in the past and board meeting minutes. He also had discussions with the management of each entity on future plans for asset sales. Based on this due diligence, the expert for the estate projected an average asset holding period of five years for LRC. Based on a capital gains tax rate of 38.8%, the present value of the capital gains taxes was estimated to be \$5.616 million, or 17.4% of LRC's net asset value. Similarly, based on an eight year turnover period using a 35.32% capital gains tax rate, the estate's expert estimated capital gains taxes of approximately \$12.455, or 23.6% of LSC's net asset value. The expert for the IRS did not talk to management and relied solely on historical asset turnover ratios in arriving at a 53-year holding period for LRC's assets and a 29-year holding period for LSC's assets. The IRS expert used identical capital gains tax rates as the estate's expert. Based on the longer asset holding periods, the IRS expert estimated a 2% built-in capital gains discount for LRC and an 8% built-in capital gains discount for LSC. In its assessment of built-in gains, the court found that because both entities had significant built-in capital gains, a built-in gain discount would be negotiated between a hypothetical buyer and seller, and believed the assumptions of the estate's expert regarding holding periods were more accurate. Accordingly, in its finding on the built-in capital gains, the Court accepted the discounts proffered by the estate's expert in their totality.

The Court then turned its attention to the respective discounts for lack of control. The Court first ruled on the lack of control discount for LRC before ruling on LSC.

For the LRC, the Court noted that each expert calculated similar lack of control discounts for LRC's farmland and related assets at approximately 15%. Both experts also used lower lack of control discounts related to LRC's securities. In estimating the lack of control discount for the LRC stock interest, the estate's expert used a weighted average to account for the fact that LRC had significantly more farmland than securities. In contrast, the IRS expert used a straight average. In its ruling on a 14.8% discount for lack of control for the LRC stock interest held by the estate, the Court found that a weighted average was appropriate given the disparity between the value of LRC's farmland and securities portfolio.

With respect to the lack of control ruling for LSC, the estate's expert relied on closed end funds, and made observations on the mean, median and standard deviation of the discounts associated with the closed end fund group. He also adjusted the measures of central tendency to account for specific attributes of LSC. Based on his analysis, the estate's expert opined an 11.9% lack of control for the estate's interest in LSC.

The IRS expert's analysis on lack of control for LSC varied significantly from the estate's expert. The IRS expert opined that a discount for lack of control is generally required only if the buyer intends to change the entity's operations. Because LSC had performed well, he asserted that a buyer would not expect a large discount for lack of control. The estate's expert analyzed a close end fund group with an average discount of 3.4%. Because of the variation in the closed end fund data observations, the estate's expert then "trimmed" the mean (removing the top and bottom 10% of observations), resulting in a trimmed average of 5.2%. Based on his analysis, the IRS expert concluded a 5% discount for lack of control for the estate's interest in LSC.

The Court concluded an 11.9% discount for lack of control attributable to the estate's interest in LSC, adopting the methodology asserted by the estate's expert.

Both the estate's expert and the IRS expert supported their respective allowances for lack of marketability by reviewing restricted stock studies. For the interest in LRC, the estate's expert opined a 36% discount, considering expectations of future cash flow, liquidity of underlying assets, and LRC's small size. The IRS expert reviewed three restricted stock studies that the estate's expert did not review for his analysis of lack of marketability for LRC. He arrived at a discount for lack of marketability of 18% by looking at private placement studies because of his contention that restricted stock studies included factors unrelated to marketability such as liquidity and corporate distress. For the interest in LSC, the estate's expert considered LSC's share transferability, expectations of future cash flow, and liquidity of LSC's underlying assets in forming an opinion of a 29.7% discount. The IRS expert reviewed the same data he analyzed for LRC. However, because LSC's assets were more readily ascertainable and saleable, its earnings history consistent, and its management competent, he concluded a 10% lack of marketability was appropriate.

The Court concluded a 25% discount for lack of marketability for LRC and a 20% discount for LSC. In its conclusion, the Court cited the outdated data relating to restricted stock discounts used by the estate's expert, and that his discounts "are higher than marketability discounts reflected in benchmark studies that included all components of a lack of marketability discount. The Court also referenced a prior valuation report for a minority interest in LSC that the same expert prepared that provided a significantly lower discount for lack of marketability.

#### **COMMENT:**

The appraisal takeaways from this opinion deal with built-in capital gains, lack of control, and lack of marketability. On the built-in capital gains issue, the Tax Court felt it was appropriate to be consistent with its prior rulings in using a net present value methodology to estimate built-in capital gains compared to using the dollar for dollar approach used by the 11<sup>th</sup> Circuit Court of Appeals in *Jelke*, which was filed in 2007. The analysis of the lack of control discount supports the contention that the appraiser should consider applying a specific discount for each major asset component held by an investment holding entity, based on an analysis of specific capital market evidence that corresponds to the asset component. The lack of marketability analysis by the Court would seem to reinforce a trend in recent opinions that "carve out" factors other than pure lack of marketability that may be inherent in the restricted stock data.

*2. Berquist v. Commissioner, 131 T.C. No. 2, Filed July 22, 2008*

This opinion involved the shareholders of University Anesthesiologists, P.C. (“UA”), an entity that provided anesthesiology services to Oregon Health & Science University Hospital (“the Hospital”). The Hospital wanted to consolidate its service providers into a §501(c)(3) tax-exempt corporation.

In time period prior to the consolidation, UA shareholders attended a conference and obtained legal and accounting advice regarding the potential tax benefits of charitable contributions that were related to such a consolidation transaction. On June 7, 1999, UA held a stockholders meeting at which the potential tax benefits of donating UA stock to the Hospital were described as offering a “huge [tax] windfall” of “150K” to each UA stockholder. An attorney engaged by UA believed his plan would maximize the amounts of charitable contribution deductions UA stockholders could claim by allowing UA stockholders to donate most of their UA stock while at the same time retaining control of UA. On September 14, 2001, 24 of 28 UA shareholders approved the proposed transaction. After the consolidation was completed, UA no longer operated as a provider of anesthesiology services, but continued in existence only to collect its accounts receivable.

In connection with the transaction, UA retained a national valuation firm to appraise UA stock. In October 2001, the valuation firm valued the stock at \$401.79 per share, which resulted in \$175,000 of charitable deductions for each shareholder. However, in January of 2002 the Hospital notified at least one UA shareholder that the Hospital would enter a book value of \$0 per share in connection with the transaction, “as the affairs of UA are wound up over the next year .... thus leaving no unencumbered residual value for the benefit of the Hospital.”

On January 29, 2002, former UA shareholders met again to discuss how they should report and claim the charitable contribution deductions with respect to their UA stock. Several shareholders indicated that based on advice from their own personal tax and legal adviser that they were considering reporting the charitable contribution at an amount lower than the amounts on Form 8283 that they had been provided. In response, UA’s attorney and accountant advised the former UA shareholders not to do so, in fear of attracting attention from the IRS. Twenty-six of twenty-eight former UA shareholders used the appraised value of \$401.79 per share for reporting their charitable deductions.

On audit of the returns of the former UA shareholders, the IRS determined that on September 14, 2001 the UA stock had no value and disallowed the charitable contributions related to UA stock in their entirety. Before trial, the IRS asserted a value for the UA stock of \$37 per voting share and \$36 per nonvoting share, and the charitable contributions were allowable to that extent.

With respect to its analysis of the two appraisals, the Court succinctly summarized the wide disparity in value by stating, “The dramatic difference between petitioners’ experts’ and respondent’s expert’s appraised value for the UA stock stems largely from the experts’ respective conclusions as to the proper valuation premise--whether to value UA as a going concern.”

In its ruling, the Court found that, “On the facts before us, a reasonably informed and willing buyer or seller certainly would have known about and would have taken into account the fact that as of September 14, 2001, there was an extremely high likelihood that by early 2002 UA would no longer be an operating entity.” The Court further found that “because petitioners’ experts’ valuations are based entirely on an incorrect premise, we choose not to rely upon their reports in determining the FMV of the donated stock.”

The taxpayers argued alternatively that the value of UA stock had a value of at least \$114 per share. However the Court did not rely on this alternative valuation because it did not appear in any of the expert reports and was not adequately explained in the briefs of the taxpayers’ counsel.

The IRS appraisal of \$35 per share of voting stock and \$37 per share of nonvoting stock incorporated significant discounts for lack of control and lack of marketability. The IRS appraiser examined merger & acquisition transactions of health care companies in 1999 and 2000 to derive a 35% discount for lack of control. He then used a restricted stock study of healthcare companies and a healthcare initial public offering study to arrive at a 45% discount for lack of marketability. Because the taxpayers could not point to, and the Court did not identify any significant flaws in the IRS appraisal, the Court adopted its value conclusions.

**COMMENT:**

Although it is well established that fair market value is the appropriate standard of value for federal tax purposes, the premise of value used can have a dramatic impact on the value conclusion derived. Therefore, it is important to use the correct premise of value given the specific facts and circumstances related to the business interest being valued.

*3. Holman v. Commissioner, 130 T.C. No. 12, Filed May 28, 2008*

The Holman<sup>1</sup> opinion dealt with three issues. The first issue was whether the transfers made by the taxpayer of Dell Computer Corporation common stock constituted indirect gifts. The second issue was whether to consider, or not consider, certain restrictions within the partnership agreement. The final issue involved the valuation of transfers of the limited partnership interests for gift tax purposes.

On November 2, 1999, Thomas and Kim Holman formed the Holman Limited Partnership (“HLP” or “the Partnership”), holding both general and limited partnership interests upon formation. On the same day the Holmans contributed Dell common stock worth approximately \$2.8 million to the Partnership. Six days later, Mr. and Mrs. Holman transferred limited partnership interests to each of their three children. The Holmans also completed gifts of limited partnership interests in 2000 and 2001.

With respect to whether the initial contribution of the Dell common stock to the Partnership was an indirect gift or not, the IRS promoted two arguments. First, the property that was transferred was Dell common stock, not limited partnership interests. The IRS also argued that the transaction should be as an integration donative transaction. In contrast, the taxpayers argued that HLP was a legally valid entity and gift partners received HLP equity interests in exchange for the Dell common stock that was contributed to the Partnership. The Court found there was no indirect gift, and in doing so, rejected both of the arguments proffered by the IRS.

On the second issue, the Court rejected the taxpayer position to consider the restrictions in the partnership agreement relating to a non-permitted assignment of a limited partnership interest. Under IRC §2703(a), “the value of any property transferred by gift is determined without regard to any right or restriction relating to the property.” However, under IRC §2703(b), the restrictions are to be considered in the valuation of property if: 1) they comprise a bona fide business arrangement, 2) they are not devices to make transfers for less than full and adequate consideration, and 3) their terms are similar to those in arm’s-length transactions. In its ruling on this second issue, the Court found that the restrictions did not meet the bona fide business arrangement and device tests.

The third issue addressed by the Court in Holman was the valuation of limited partnership interests related to transfers that occurred in 1999, 2000 and 2001. The Court addressed three specific valuation issues as follows: 1) the net asset value of the HLP as of the respective valuation dates, 2) the lack of control discount, and 3) the lack of marketability discount.

Both valuation experts agreed as to the net asset value of HLP as of the 1999 valuation date, but disagreed with respect to the 2000 and 2001 dates of value. The taxpayer’s expert relied on the closing price for Dell common stock for the 2000 and 2001 gifts, while the IRS expert relied on the averages of the Dell stock on the date of the gifts. In its resolution of this issue, the Court cited IRC §25.2512-2(b)(1) that provides, “In general, if there is a market for stocks \* \* \*, on a

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<sup>1</sup> It is important to note that the Holman opinion is a “regular” tax court opinion. Unlike a “memorandum” opinion, regular tax court opinion has precedential weight.

stock exchange, in an over-the-counter exchange, or otherwise, the mean between the highest and lowest quoted selling prices on the date of the gift is the fair market value per share.” The taxpayer’s expert argued that because the gifts being valued were partnership interests that do not trade in a public market, the regulation was not applicable. The Court ruled for the IRS on this issue, citing that the taxpayer provided no authority for disregarding the regulations.

With respect to the lack of control discount, both appraisers substantiated their discounts based on an analysis of closed-end investment companies. The taxpayer’s expert relied on seven specialized funds while the IRS expert relied on a broader group of general equity funds, although in cross examination the taxpayer’s expert admitted that his report failed to explain why he included the specialized funds in his samples. The taxpayer’s expert calculated only a mean for the data he reviewed, while the IRS expert calculated the median, mean and interquartile means for the general equity closed end funds. The taxpayer’s expert opined 14.4%, 16.3% and 10.0% lack of control discounts for the 1999, 2000 and 2001 gifts respectively. The IRS expert opined 11.2%, 13.4% and 5.0% for the corresponding time periods for his lack of control discount. In its critique of the valuation evidence presented to it, the Court found issue with the adjustments of the taxpayer’s expert to account for qualitative factors. The Court also stated that the approach of the IRS expert was more thoughtful, and by following the lead of the IRS expert, constructed data samples from the data common to both appraisers. Based on the calculated interquartile mean of the sample data, the Court concluded lack of control discounts of 11.32%, 14.34%, and 4.63% to the three gifts in question.

The final issue for resolution by the Court involved the discount for lack of marketability. Both experts used restricted stock data to substantiate their discounts. The taxpayer’s expert calculated a median discount of 24.8% and a mean discount of 27.4% from his restricted stock transactions. The IRS expert segregated the restricted stock studies he reviewed into three categories, as follows: 1) pre-1990 studies, before the Securities and Exchange Commission (“SEC”) adopted Rule 144, 2) 1990 to 1997 studies that reflected limited access to a resale market under Rule 144A, and 3) the two years after the revision of 144A, which reduced the holding period associated with restricted stock from two years to one year. The average discounts associated with the restricted stock studies in the first category was 34%, the second category was 22%, and the third category was 13%.

The taxpayer’s expert, based on the calculated median and mean discounts reflected in the restricted stock data, considered the investment quality of the limited partnership units and that the units had “virtually no ready market.” Without any detailed elaboration, other than “considering all relevant factors,” he opined a discount for lack of marketability of at least 35%.

The IRS appraiser employed a novel approach to substantiating his discount for lack of marketability. He opined that the lack of marketability was largely reflected by the change in the discounts observed between the pre-1990 restricted stock studies and the seven year period of restricted stock data following 1990. This change in percentage, he said, was relevant to private investment companies such as HLP, not subject to holding periods. He promoted the idea that in the case of HLP the holding period had little, if any, influence. After adjustment for factors specific to HLP, he opined a 12.5% discount for lack of marketability.

The Court's conclusion with respect to lack of marketability found the testimony of the IRS expert more credible. The Court cited its lack of confidence in the analysis of the taxpayer's expert. In particular, it criticized his assertion that there was no available market, which implied a 100% discount for lack of marketability, yet the expert arbitrarily stopped at 35%. Interestingly, the Court also agreed with the IRS expert's assertions with respect to holding period. In its conclusion and final assessment the Court stated, "we cannot determine any better estimate of an appropriate marketability discount" than that of the IRS expert's "estimate, 12.5%, and we find accordingly."

**COMMENT:**

As the *Holman* opinion constitutes a full Tax Court opinion that has precedential authority, appraisers that practice in a federal tax environment would be well advised to consider a number of issues addressed in the opinion. First, it is now clear with the *Holman* opinion that in the determination of net asset value for an investment holding entity the marketable securities should be priced at the mean of the high and low of the daily trading price as of the date of value, consistent with the regulations on this issue. Second, in its assessment of the lack of control discount, the Court had a preference for the analysis to include interquartile measures of central tendency, rather than means and medians for the entire data set being analyzed. Third, *Holman*, as was the scenario in *Litchfield*, again highlights the recent tendency of the Court to "parse" the restricted stock data to remove factors unrelated to marketability.

4. Astleford v. Commissioner, T.C. Memo 2008-128, May 5, 2008

Jane Astleford formed the Astleford Family Limited Partnership (“AFLP”) in 1996. At formation she retained a 10% general partnership interest and gave each of her three children a 30% limited partnership interest. The limited partners made no capital contributions at the time of the gifts.

AFLP was initially funded in 1996 with an adult assisted living facility. In 1997, she contributed a 50% general partnership interest in Pine Bend Development Company (“PBDC”), a real estate holding entity that held 3,000 acres of land. She transferred additional limited partnership interests after the contribution of the PBDC general partnership interest.

In connection with the 1996 and 1997 gifts of AFLP, Mrs. Astleford filed federal gift tax returns that were subsequently audited. On audit, the IRS asserted higher values for the underlying real property and lower lack of control and lack of marketability discounts associated with the transferred interests.

At trial, there were two business valuation related issues in dispute. The first issue was whether the 50% interest in PBDC should be valued as a general partnership interest or an assignee interest. The second issue dealt with the applicability and magnitude of discounts for lack of control and lack of marketability.

With respect to the first issue, the taxpayer treated the 50% interest in PBDC as an assignee interest. However the IRS pointed out that the PBDC partnership resolution treated the transfer as a transaction involving all rights and benefits. The Court agreed with the IRS arguments in this regard and found that the taxpayer funded AFLP with a 50% general partnership interest.

The second business valuation issue, the question of the size of the discounts, was an issue first at the PBDC level, and subsequently, for the interests in AFLP that were transferred. With respect to the 50% interest in PBDC, the taxpayer concluded a combined 40% discount for lack of control and lack of marketability based on an analysis of publicly registered real estate limited partnerships (RELPs). The IRS expert believed that because the 50% general partnership interest in PBDC was an underlying asset of AFLP, the discounts at the AFLP level eliminated the need for discounts at the PBDC level. However, the Court noted in a footnote that in prior opinions the IRS and the Court itself had applied layered discounts in multi-tiered entities. Accordingly, the Court held that, “Lack of control and lack of marketability discounts at both the Pine Bend level and the AFLP parent level are appropriate.” In its finding of a 30% combined discount for lack of control and lack of marketability, the Court based its conclusion on evidence introduced by the taxpayer’s appraiser, with modifications<sup>2</sup>.

With respect to the discounts at the AFLP level, the Court first reviewed the discount for lack of control. In his substantiation of the lack of control discount at the AFLP level, the taxpayer’s expert analyzed nine RELP comparables, concluding on a 45% discount for the 1996 gifts and a

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<sup>2</sup> Interestingly, the Court applied discrete discounts for lack of control and lack of marketability later in its analysis at the AFLP level.

40% discount for the 1997 gifts. Based on differences in leverage and cash distribution levels, the Court found that the discounts should be lower than the 38% average discount reflected by the RELP data. In contrast to the taxpayer's expert, the IRS expert reviewed REIT data to support his lack of control discount. After adjusting the REIT data for liquidity considerations, the IRS expert concluded 7.14% and 8.34% discounts for lack of control for the 1996 and 1997 transfers respectively. The Court was in agreement with the fundamentals of the approach used by the IRS expert, but concluded that the discounts seemed unreasonably low. The Court arrived at discounts of 16.17% and 17.47% for the 1996 and 1997 gifts, respectively, by making a further adjustment for liquidity to evidence presented.

The final issue for decision was the lack of marketability discount related to the AFLP interests transferred. For the 1996 gifts, the taxpayer's appraiser estimated a 15% discount and the IRS expert concluded a 21.23% discount. The Court concluded that the higher discount of 21.23% was appropriate, however there is no discussion in the opinion as to how the marketability discount was supported by either appraiser. The parties to this dispute stipulated to a 22% discount for the 1997 gifts.

**COMMENT:**

Arguably, because the analysis of the taxpayer's appraiser for the lack of control discount did not adequately address the differences in leverage and cash distributions between the RELP data and the business interest being valued, the Court ruled for a significantly lower discount. Consideration of these factors may have resulted in another conclusion by the Court.

5. *Estate of Jelke v. Commissioner*, 507 F. 3d 1317 (11<sup>th</sup> Cir. 2007), Filed November 15, 2007<sup>3</sup>.

The primary issue for decision by the 11<sup>th</sup> Circuit Court of Appeals in *Jelke* was the quantification of the built-in capital gains in determining the fair market value of a 6.44% interest in a C corporation that held marketable securities. This case was on appeal from the Tax Court which ruled that a reduction to value based on the built-in gains should be based on the present value of the tax liability when it is likely to be incurred in the future. The 11<sup>th</sup> Circuit vacated and remanded the Tax Court opinion with instructions to recalculate the built-in gains liability on a dollar-for-dollar basis as if 100% of the built-in gains liability had been realized as of the date of value. On October 6, 2008 the United States Supreme Court denied the Internal Revenue Service Commissioner's petition for *writ of certiorari*, leaving conflicting precedent at the federal appellate court level.

The Tax Court heard the case as the court of original jurisdiction. Frazier Jelke III died on March 4, 1999 holding a 6.44% interest in the common stock of a C corporation whose assets consisted of a diversified portfolio of marketable securities. At trial the taxpayer's expert posited that the liability for built-in capital gains inherent in the corporation's marketable securities should be assessed on a dollar-for-dollar basis based on an assumption for liquidation on the valuation date.<sup>4</sup> The taxpayer's expert also opined to a 25% discount for lack of control and a 35% discount for lack of marketability. In contrast, the IRS expert contended that the discount for built-in capital gains should be estimated through a present value analysis over the sixteen-year time period during which the corporation's assets could be expected to be sold at which time the inherent built-in capital gains would then be realized. The IRS expert also opined to a 5% discount for lack of control and a 10% lack of marketability discount. In its ruling, the Tax Court sided with the IRS expert, concluding that the discount for built-in gains should be estimated through a present value analysis over the likely time period that the corporation's assets would be sold, the time at which the related tax liability is triggered. The Tax Court also ruled that discounts of 10% for lack of control discount and 15% for lack of marketability were appropriate.

The Tax Court opinion was appealed by the taxpayer to the 11<sup>th</sup> Circuit Court of Appeals in Atlanta. In its ruling, the 11<sup>th</sup> Circuit Court relied on the *Estate of Dunn v. Commissioner*, 301 F.3d 339 (2002) (5<sup>th</sup> Cir. 2002) and assessed a dollar-for-dollar unrealized capital gains discount.

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<sup>3</sup> The complete citation for the *Jelke* opinion is as follows: *Estate of Jelke v. Commissioner*, T.C. Memo 2005-131, *vacated and remanded*, 507 F. 3d 1317 (11<sup>th</sup> Cir. 2007), *cert. denied*, 129 S. Ct. 168 (2008).

<sup>4</sup> It is important to note that it is not entirely clear from the original Tax Court memorandum opinion as if the liquidation assumption was restricted to valuation of the assets of the C corporation or that it extended to the valuation of the equity interest in the C corporation. The Tax Court made the following comment in a footnote to the opinion on page 36, which would suggest that the taxpayer's expert performed the valuation of the equity interest on a liquidation premise, as follows: "We must note that Mr. \_\_\_\_\_ reduces CCC's asset value by the entire \$51,626,884 built-in capital gain tax liability on the assumption of a liquidation on the valuation date, whereas for purposes of his lack of marketability analysis he relies on the premise that CCC will not be liquidated for at least 20 years. In each instance, the approaches, although internally inconsistent, produce the best results for his client (the estate)."

In its ruling the Court dismissed the IRS argument that *Dunn* was distinguishable from the facts in *Jelke* as the interest being valued in *Dunn* was a controlling interest<sup>5</sup>. It is important to note that the 11<sup>th</sup> Circuit opinion consisted of a two judge majority and a blistering dissenting opinion. In his dissent on the built-in gain issue, Judge Carnes characterized the majority opinion as adopting the “rule of least effort” and “taking the easy way out.” The 11<sup>th</sup> Circuit panel declined to rule on the lack of control and lack of marketability issues finding no error in the Tax Court’s findings on these issues.

#### **COMMENT:**

The decision by the 11<sup>th</sup> Circuit in *Jelke* may raise as many questions as it answers. With the Supreme Court’s denial for *writ of certiorari*, there is conflicting precedent with opinions from the 5<sup>th</sup> and 11<sup>th</sup> Circuits favoring a dollar-for-dollar approach to built-in gains and the Second and Sixth Circuits appearing to favor other ways to assess the discount.

For the business appraisal community, it is important to address the importance of the premise of value on this issue. The Uniform Standards of Professional Appraisal Practice mandate that business appraisers state the premise of value.<sup>6</sup> The written opinions in *Jelke* did not explicitly state whether either appraiser used a going-concern premise of value or a liquidation value premise. As noted previously, the Tax Court opinion in *Jelke* refers to “the assumption of a liquidation on the valuation date” by the taxpayer’s expert. Because the premise of value is a fundamental aspect in how an appraiser deals with issues such as built-in capital gains, business appraisers are well advised to explicitly state the premise of value in their reports, cite the source of the definition as required by USPAP Standard 10, and explain the rationale behind the selection of a specific premise of value. To the extent the appraisers in *Jelke* did not do so in their reports, this may have contributed to ongoing controversy with respect to dealing with built-in capital gains.

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<sup>5</sup> On this point the 11<sup>th</sup> Circuit Court stated, “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.”

<sup>6</sup> Refer to Uniform Standards of Professional Appraisal Practice 2008-2009 Edition, Standards Rule 10-2(a)(vi).

## **II. FACTORS TO CONSIDER WHEN APPRAISING AN FLP INTEREST**

A successful challenge by the IRS on the validity of the FLP entity itself can potentially damage the reputation of an appraiser who valued the decedent's or transferor's interest in such entity. Therefore, it is important to recognize the "bad facts" or red flags in the FLP prior to completing the appraisal that will cause the IRS to pursue an audit, and ultimately prevail. Below is a list of factors relating to the formation and operation of an FLP which have been held by courts and the IRS to contribute to the disregard of an FLP for estate and gift tax purposes.

### **A. Formation:**

- Partner transferred virtually all of his or her assets into the FLP, including personal and non-business assets, and did not retain sufficient assets to meet personal obligations and expenses.
- Partner transferred his or her personal residence to FLP and continues to live in the residence rent-free.
- FLP was created without meaningful negotiations among the contributing parties.
- FLP or partners have failed to follow organizational formalities, boilerplate requirements and/or state law filing requirements; documentation is insufficient or absent.
- Parties do not have stated legitimate and significant non-tax purposes in forming the FLP.
- Attorney communications (if made available) relating to formation focus strictly on valuation discounts as the purpose for creating the FLP.
- Significant gap in time exists between formation of the FLP and actual funding by the partners.
- Sequence of formation and funding is improper.
- FLP was formed and funded when the transferor was in poor health or terminally ill.
- Organizational documents contain significant drafting errors.
- Durable power of attorney or similar document is used as basis for transferring assets to FLP on behalf of an incompetent or elderly individual.
- Anticipated period between initial funding and gift of FLP interests is very short (i.e., assets contributed to partnership are not sufficiently exposed to market risk of fluctuations in value prior to transfers of partnership interests. This determination depends on the type of assets transferred to the FLP. For example, consider the risk of fluctuations in the value of publicly-traded securities versus real estate).
- Partners did not receive partnership interests in proportion to the value of assets actually contributed by each to the FLP.
- FLP assets are commingled with assets individually owned by partners (e.g., FLP does not have a separate bank account).
- Formal documents to evidence transfer of assets contributed to FLP not completed.

### **B. Operation:**

- Partner utilizes FLP assets for personal use, such as paying personal expenses from FLP account.

- Disproportionate distributions made among the partners (distributions are not made in proportion to each partner's percentage interest in the FLP).
- Distributions not reflected on partnership books, or reflected as loans or payment of management expenses.
- Partners and partnership disregard operational formalities, boilerplate requirements and/or recurring state law filing requirements; documentation is insufficient or absent.
- Partnership makes personal loans to partners.
- Primary partner who transferred most of the assets to the partnership has retained or exercised excessive powers over the operations and distributions of the partnership.
- FLP does not conduct business activities or ongoing management of FLP assets.
- Distributions were made to pay the estate taxes or other personal expenses of a partner
- FLP assets are commingled with assets individually owned by partners (e.g., FLP does not have a separate bank account).
- Tax returns for the FLP have not been filed.
- Primary contributing partner manages the FLP without input from managing partner(s).
- Partners have disregarded terms of partnership agreement.
- An express or implied agreement exists with the contributing partner that he or she will continue to receive the income from certain assets contributed to the FLP.
- FLP is not a business operated for profit.

### **III. THE ATTORNEY – APPRAISER RELATIONSHIP**

#### **A. Engagement considerations**

In most situations, it is advisable that the estate planning attorney engage the appraisal expert. This will provide the opportunity for the taxpayer to assert that any written documentation is privileged, which may be an important issue to the extent the valuation is challenged. Typically, clients will not be familiar with these issues and well-qualified counsel is in a good position to educate the client on the important concepts related to attorney work product privilege. To the extent the attorney engages the appraiser, the client of the appraiser is, from a technical perspective, the attorney. The attorney executes any contractual documents and provides the compensation for the appraiser's services. The work product, consisting of both oral conclusions of value and written reports, is communicated to the attorney.

#### **B. Attorney work product privilege**

To the extent attorney work product privilege is asserted, there are some practical procedures that are warranted to supplant this contention. As noted previously, in an attorney privilege context the engagement letter is addressed to counsel. In terms of written communication such as letters and emails, it is a good practice to label such correspondence including hard copy letters and electronic correspondence as Attorney Work Product to support the assertion of the attorney work product privilege. The practice of sending copies of work product, even blind copies, to the ultimate client may not be advisable depending on the preference of counsel. To the extent privileged work product is the subject of a subsequent

subpoena from the IRS, it is appropriate practice for the appraiser to refer the subpoena to counsel for resolution. Communication of any correspondence or information to someone outside the attorney client relationship will void the privilege. Therefore, be careful not to include in any meeting, telephone conference or by copy of written communication to anyone outside the privileged relationships.

**C. *United States of America vs. Richey*, 103 AFTR 2d 2009-1228, Filed March 6, 2009.**

This opinion dealt with the efforts of the IRS to enforce its summons for the workfile of Mark Richey, a real estate appraiser engaged by the attorney of the taxpayer to value a conservation easement. The IRS summons of the workfile was related to an administrative investigation by the IRS.

The appraiser was hired by counsel in anticipation of potential litigation over the value of the deduction for the conservation easement. The final report of the appraiser was filed with the 2002 tax return and indicated a 29% reduction in value as a consequence of having the real property encumbered by the conservation easement. Page four of the final appraisal report stated, "Other than what is attached to this appraisal, all of the documentation is contained within my files."

The IRS filed a Notice of Deficiency for the tax years 2003 and 2004 as the conservation easement deduction extended into those tax years. The IRS contended that the appraiser's workfile was needed to evaluate the final appraisal report that was provided to the IRS with the 2002 tax return. In response to the summons the appraiser turned over control of his workfile to the taxpayer's lawyer and did not respond to the summons of the IRS.

The taxpayer's counsel contended that the summons should be quashed as the workfile of the appraiser is subject to attorney-client privilege and attorney work product doctrine as it was undisputed that the appraiser was hired in anticipation of potential litigation. In contrast, the IRS maintained that the workfile was not subject to the privilege or the doctrine.

The Court ruled that the workfile at issue did not have to be turned over to the IRS. The appraisal was prepared at the direction of the law firm to aid the attorney in providing legal advice to the taxpayer and any notes in the workfile were therefore protected by the attorney-client privilege. The Court also ruled that the appraisal work file was prepared in anticipation of future litigation over the value of the conservation easement and was considered protected under the work product doctrine. In its ruling, the Court also stated, "Disclosing the final appraisal report does not as a matter of law open the workfile to discovery by the IRS."

In its conclusion, the *Richey* Court also ruled that the IRS had the burden of proof to explain why the appraisal report was insufficient to explain the appraiser's conclusions. The Court found that the IRS did not meet the burden of proof and "has not established that the workfile is not protected by the attorney-client privilege or work product doctrine."

**COMMENT:**

The adage, “begin with the end in mind” is appropriate in light of the *Richey* opinion. The fact that the attorney engaged the appraiser resulted in the ability for the counsel to successfully argue the attorney-client privilege and work product doctrine. Many attorneys will appreciate inquiries from the appraiser as to whether they intend to assert the work product doctrine for appraisal related documentation. The appraiser may then draft the engagement letter accordingly.

It is also worth considering whether the language the appraiser used in his report in referring to his workfiles in some way contributed to the strenuous pursuit by the IRS in this matter. The language used by the appraiser may have implied there was additional information regarding the appraisal analysis not contained in the appraisal report. To the extent a similar statement is included in an appraisal report, the statement should be drafted with care in light of this opinion.