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16 Mistakes to Avoid in Valuations (According to Tax Court Decisions)

By L. Paul Hood, Jr., JD, LLM; and Timothy R. Lee, ASA

Quoting directly from Tax Court decisions, the authors describe 16 categories of mistakes that valuation experts have made in disputes over the value of privately held companies.

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VALUATION

16 Mistakes to Avoid in Valuations (According to Tax Court Decisions)

By L. Paul Hood, Jr., JD, LLM; and Timothy R. Lee, ASA

Business valuation textbooks, training manuals, and conference presentations may do a good job of teaching the right ways to conduct valuations. But in some respects, the most authoritative teacher of what is right and, just as importantly, what is wrong is the decision of the court in a dispute over the value of a privately held business or shares thereof.

In this article, we have collected 16 examples of mistakes made by valuation experts, as reported in federal courts in tax decisions. It is important to note that there are two sides to every story, and courts do not always get it right. For this reason, we do not name any valuators in this collection of mistakes to avoid.

1. Lacking Explanation Needed to Replicate. No matter how "correct" your conclusion of value seems to be, the court may not accept it if you do not provide sufficient details and explanations about how you arrived at that conclusion. Another valuator should be able to replicate your work after reviewing your report or work-papers. In *Winkler Estate v. Commissioner*,[1] the Tax Court provided one of the best arguments for a free-standing, comprehensive appraisal report:

> Respondent's expert appears to be extremely well qualified but he favored us with too little of his thought processes in his report. In another area, for example, his report briefly referred to the projected earnings approach, but the discussion was too abbreviated to be helpful. His testimony on the computer models he used, while unfortunately never developed by counsel, suggested that a lot of work had been done but simply not spelled out in his report. That may also be the case in his price-to-earnings computations, but the Court cannot simply accept his conclusions without some guide as to how he reached [them].

2. Pure Reliance on Case Law for Discount. What constitutes the proper valuation discount is essentially case-by-case factual issue. Valuation discounts can be factored in as an element of the discount rate (sometimes characterized as implicit treatment) or applied as direct adjustment(s) to value after the enterprise level value has been determined. As such, pure reliance on case law for determination of valuation discounts is inadvisable, particularly when the economics, facts, and circumstances of the precedent cases do not reasonably parallel those of the subject interest. Nevertheless, some valuators have resorted to reliance on case law for determination of valuation discounts. In *Berg Estate v. Commissioner*,[2] the Tax Court was unimpressed with this practice:

> The fact that petitioner found several cases which approve discounts approximately equal to those claimed in the instant case is irrelevant.

3. Failure to Find Available Information. Very few things look worse for a valuator than when he or she cannot find information that the opposing valuator finds. This happened in *Barnes v. Commissioner*:[3]

> [Valuator A] used the market or guideline company approach to estimate the value of Home and Rock Hill stock, but he excluded three companies that [Valuator B] used as comparables because he did not have their market trading prices as of the

1 T.C., Memo 1989-231. See also Former IBA Business Appraisal Standards Sec. 1.8. See also *True Est. v. Comr.*, T.C. Memo 2001-167, aff'd., 390 F. 3d 1210 (10th Cir. 2004).

2 T.C. Memo 1991-279.

3 T.C. Memo 1998-413.

valuation date. In contrast, [Valuator B] apparently easily obtained the stock prices by contacting the companies.

4. Insufficient Explanation of Assumptions. It is important to explain any assumptions that you make in a valuation report. In *Bailey Estate v. Commissioner*,[4] the Tax Court criticized the appraiser for failing to do so:

> [He] offered no explanation or support for any of the many assumptions that he utilized in the just-described analysis. Nor did he offer any explanation or support for his conclusion that the discount related to stock sale costs should be 6 percent. An expert report that is based on estimates and assumptions not supported by independent evidence or verification is of little probative value or assistance to the Court.

5. Failure to Explain Weightings. It is essential that you include a significant discussion in the valuation report of how you weighted products of various multiples in your conclusion of value. This did not happen in *True Estate v. Commissioner*,[5] as the Tax Court pointed out:

> [The valuator's] report's guideline company analysis was even more questionable. It provided no data to support the calculations of…pretax earnings and book value for either the comparable companies or True Oil. Further, [he] did not explain the relative weight placed on each factor….Without more data and explanations, we cannot rely on [his] report's valuation conclusions using the guideline company method.

Where different valuation methods yield differing indications of value, you must be very clear about how you use them to arrive at a conclusion of value. It sometimes is tempting to simply weight the indications equally. What is more important, however, is to have an explanation for the weighting of the indications of value, whatever they might be. In *Hendrickson Estate v. Commissioner*,[6] the Tax Court criticized the work of a valuator who simply gave the indications of value equal weight without bothering to explain why.[7]

6. Failing to Justify Capitalization or Discount Rates. You cannot simply pull a capitalization or discount rate out of thin air; you must justify it. This seems to have been an issue in *Morton v. Commissioner*:[8]

> [The valuator] testified that venture capitalists generally require between 30- and 60-percent return, and that his 35 percent discount rate was "conservative." However, [he] did not provide any objective support, either at trial or in his expert report, for selecting a discount rate in this range.

7. Inadequate Guideline Company Data. You are usually required to include the names of guideline companies in the valuation report. This was not done in *Jann Estate v. Commissioner*,[9] where the Tax Court pointed out:

> [The valuator's] report referred to comparable companies but did not identify them; did not state whether [he] used average earnings or a weighted average earnings in his analysis; referred to a standard industrial classification number but did not identify it; and did not explain how he arrived the price-earnings ratio of 9.8.

In *True Estate v. Commissioner*,[10] the Tax Court criticized one of the taxpayer's valuators, stating:

> [He] provided no data showing: (1) How he computed the guideline company multiples or the Belle Fourche financial fundamentals, (2) which of three multiples he applied to Belle Fourche's fundamentals, or (3) how he weighed each resulting product. Without more information we cannot evaluate the reliability of [his] results.

8. Failure to Think Like an Investor. In *Newhouse Estate v. Commissioner*,[11] the Tax Court concluded:

> None of respondent's expert witnesses testified that they would have advised a willing buyer to use the subtraction method in deciding the value of the stock. None could testify that they

4 T.C. Memo 2002-152. See also, for example, NACVA/IBA Professional Standards Secs. IV(G)(9) and V(C)(11).
5 T.C. Memo 2001-167, aff'd., 390 F. 3d 1210 (10th Cir. 2004).
6 T.C. Memo 1999-278. See also Pratt with Niculita, *Valuing a Business, 5th Ed.*, McGraw-Hill, NY, 2008, pp. 477-482.
7 Editor's note: Some valuation books include complete chapters on reconciling the three approaches (market, asset, and income). An example is Chapter 15 of *The Market Approach to Valuing Businesses*, 2nd Edition, by Shannon P. Pratt and Alina V. Niculita, Wiley, NJ, 2006.
8 T.C. Memo 1997-166.
9 T.C. Memo 1990-333. See also AICPA Statement on Standards for Business Valuation, Paragraph 61.
10 T.C. Memo 2001-167, aff'd., 390 F. 3d 1210 (10th Cir. 2004).
11 94 T.C. 193 (1990).

had ever advised the use of the subtraction method in advising buyers or sellers of closely held stock in any comparable situation.

9. Lack of Independence. The work of valuators and appraisers must be independent, which means having no personal interest in the company being valued or the outcome of litigation. In fact, appraisers usually must certify that they are independent.[12]

In *McCormick Estate v. Commissioner*,[13] the Tax Court noted the following about a lack of independence:

> Petitioners' proffered 'expert' was John McCormick III, son of petitioner.

In *Cook Estate v. Commissioner*,[14] the Tax Court disregarded testimony of a person who was too close to the action:

> [The appraiser's] valuation of the stock at issue is not persuasive because of his self-interest. [He] is....president of Central Trust Bank...and the co-executor of Howard Winston Cook's estate.

10. Improper Classification of Subject Company. In *Bennett Estate v. Commissioner*,[15] the Tax Court felt that the IRS appraiser failed to properly characterize the subject company:

> ...in his report, [the valuator] should have characterized Fairlawn as a corporation actively engaged in commercial real estate management rather than wholly as an investment or holding company.

11. Inconsistency. Contradicting your own assertions without adequate explanation can undermine your authoritativeness, whether it's done within a single valuation report, or from one report to another, or between writings of various kinds. For example, assumptions used in more than one valuation approach, within a single report, must be consistent. That rule was violated in *Bell Estate v. Commissioner*:[16]

> Furthermore, the rates of return applied by [the valuator] in the excess earnings method bore no relationship to the capitalization rate [he] used in the capitalization of income stream method. We believe his choice of varying rate indicates a result-oriented analysis. An appropriate capitalization rate is determined by the comparable investment yield in the market not by the choice of a valuation method. [The valuator] made little effort to identify comparable investments.

Any significant discrepancy between your report and your testimony can compromise your credibility, as the Tax Court demonstrated in *Moore v. Commissioner*:[17]

> First, his report and trial testimony are inconsistent in that they indicate different methodologies for valuing the partnership interests. The report indicates that he valued the interests by discounting the fair market value of the business to reflect the lack of control and illiquidity associated with the minority interests. His trial testimony indicates that he valued the partnership interests under the procedure prescribed in Rev. Rul. 59-60, 1959-1 C.B. 237.

Valuators must use commercially available data consistently as well. In *Klauss Estate v. Commissioner*,[18] the Tax Court said that

> [The valuator] testified that it is appropriate to use the Ibbotson Associates data from the 1978-92 period rather than from the 1926-92 period because small stocks did not consistently outperform large stocks during the 1980s and 1990s. We give little weight to [his] analysis. [He] appeared to selectively use data that favored his conclusion. He did not consistently use Ibbotson Associates data from the 1978-92 period; he relied on data from 1978-92 to support his theory that there is no small-stock premium but used an equity risk premium of 7.3 percent from the 1926-92 data (rather than the equity risk premium of 10.9 percent from the 1978–92 period.

In *Caracci v. Commissioner*,[19] the Tax Court used the valuator's past writings against him in the selection of a price-to-revenue multiple:

> Moreover, in an article published [in *Intrinsic Value*] in the spring of 1997, [the valuator wrote] that for the prior

12 See for example 2010-2011 USPAP Ethics Rule line 207, NACVA/IBA Professional Standards Sec. II(J), Former NACVA Professional Standards Sec. 1.2(k), ASA BVS Sec. III(A), Former IBA Business Appraisal Standards Section 1.3, and AICPA Statement on Standards for Valuation Services Paragraph 15.
13 T.C. Memo 1995-371.
14 86-2 USTC Par. 13,678 (D.C. W.D. Mo. 1986).
15 T.C. Memo 1993-34.
16 T.C. Memo 1987-576.
17 T.C. Memo 1991-546.
18 T.C. Memo 2000-191.
19 118 T.C. 379 (2002), rev'd 456 F. 3d 444 (5th Cir. 2006).

two years, a standard market benchmark for valuing traditional visiting nursing agencies, such as the Sta-Home tax-exempt entities, was a price-to-revenue multiple of .55. We fail to understand why the Sta-Home tax-exempt entities had a much lower multiple of .26.

There may be a legitimate basis for valuing the same interests using different methods in sequentially issued reports. But in *True Estate v. Commissioner*,[20] the Tax Court found that the valuator's inconsistent application of valuation methodology was a problem, commenting:

> [His report] calculated the equity value of Dave True's 68.47 percent interest in Belle Fourche on a fully marketable non-controlling basis without first valuing the company as a whole. This significantly departed from the initial…report's guideline company approach, which first valued the company on a marketable controlling basis, and then applied a 40 percent marketability discount. Even though both reports used the guideline company method, we believe the approaches were substantially different and find it remarkable that both reports arrived at the same ultimate value of roughly $4,100,000 for Dave True's interest. This suggests that the final…report was result-oriented.

Finally we have an example of inconsistent use of pre- and post-tax figures. In *Dockery v. Commissioner*,[21] the valuator

> misapplied the price/earnings capitalization rate of 5 used in *Estate of Feldmar* to convert Crossroads' weighted average earnings, in that the Court in *Estate of Feldmar* applied the capitalization rate to post-tax earnings and [the valuator] applied it to pre-tax earnings.

12. Incorrect Definitions. In *Hall Estate v. Commissioner*,[22] the Tax Court determined that the valuator had incorrectly defined cash flow:

> In its application of the discounted future cash flow valuation, [he] incorrectly defined cash flow as net income plus depreciation, omitting consideration of deferred taxes, capital expenditures, and increases in working capital.

In Heck *Estate v. Commissioner*,[23] the Tax Court determined that the IRS appraiser defined the term "guideline company" too narrowly:

> [The appraiser] argues that only companies that are 'primarily champagne/sparkling wine producers like Korbel' constitute permissible guideline companies. Because no such publicly traded company existed, Dr. Bajaj rejected the market approach. We find [the appraiser's] approach to be unduly narrow (in theory), in light of the case law cited in the text.

13. Making the Hypothetical Buyer Too Real. The buyer and seller in the fair market value calculus must be hypothetical. In *Simplot v. Commissioner*,[24] the Ninth Circuit called down the Tax Court for failing to adhere to this standard, noting:

> The Tax Court in its opinion accurately stated the law: 'The standard is objective, using a purely hypothetical willing buyer and willing seller.…The *hypothetical* persons are not specific individuals or entities.' The Commissioner himself in his brief concedes that it is improper to assume that the buyer would be an outsider. The Tax Court, however, departed from this standard apparently because it believed that 'the hypothetical sale should not be constructed in a vacuum isolated from the actual facts that affect value.' Obviously the facts that determine value must be considered.
>
> The facts supplied by the Tax Court were imaginary scenarios as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect with Simplot children or grandchildren and what improvements in management of a highly successful company an outsider purchaser might suggest. 'All of these factors,' that is, all of these imagined fact, are what the Tax Court based its 3 percent premium upon. In violation of the law the Tax Court constructed particular possible purchasers.

14. Undue Reliance of the Work of Other Valuators. It is not unusual for a business valuator to rely in part on the efforts of a colleague, often a real estate or other personal/tangible property appraiser. The relying valuator cannot blindly rely on the work of others, but must make some baseline assessment of the accuracy and completeness of the other appraiser's work. In *Northern Trust Co. v. Commissioner*,[25] the Tax Court

20 T.C. Memo 2001-167.
21 T.C. Memo 1998-114. See also ASA BVS-Sec. IV(JV)(D).
22 92 T.C. 312 (1989)
23 T.C. Memo 2002-34.
24 249 F. 3d 1191 (9th Cir. 2001).
25 87 T.C. 349, aff'd sub nom. *Citizen's Bank & Trust v. Commissioner*, 839 F. 2d 1249 (7th Cir. 1988).

criticized a valuator's opinion, noting:

> [He] explained that he relied on the opinion of several local real estate appraisers [but admitted that those appraisers] never viewed the property prior to determining the appropriate adjustments. Indeed, the record contains no evidence explaining the basis of these adjustments.

15. Reliance on an Irrelevant Study. You have a duty to investigate or otherwise inquire about research, studies, reports, and other information on which you rely. In *Kraft, Inc., v. Commissioner*,[26] the court criticized the use of incomplete data:

> Foremost is that the data used by [the valuator] from Table No. 58 of the Pitcher Report, included in Exhibit 208, and used in the 'Knutson formula,' cannot reasonably be construed to represent conditions in milk markets elsewhere in the United States, or even within the New York City metropolitan area. It is true that the Pitcher Report was a detailed study of the milk market in New York State, rich with anecdotal stories and complex analyses of a very troubled industry crying for help from its elected and appointed government officials. Nonetheless, the data used by [the valuator] was only for the New York City metropolitan area; it did not include data gathered from dairies statewide, from other New York State cities, and from the larger NYC metropolitan area dairies. The failure to include data from the larger dairies is significant.

26 T. C. Memo 1988-511. See also 94-1 USTC Par. 50,080 (Cl. Ct. 1994).

16. Cherry-picking Valuation Multiples. In *Wall v. Commissioner*,[27] the Tax Court had this to say about the valuator's narrow selection of multiples:

> It did not use all the guideline guideline company multiples but instead picked and chose among the lowest….[The valuator's] use of the two or three lower multiple companies is inconsistent with the conclusion expressed elsewhere in her report that, even after the decline in Demco's earnings had been taken into account, Demco's profitability and risk levels were close to or at the industry norm. It also may be inconsistent with her conclusion that the seven companies she identified as comparable were in fact comparable to Demco.

In *Gallo Estate v. Commissioner*,[28] the Tax Court was even more pointed in its cherry-picking criticism:

> In valuing Gallo under each of the five methods based on comparables that he used, [the valuator] assigned to Gallo ratios that would result in the highest possible valuations. [His] method was pervasive and absolute: he made no real attempt to compare Gallo with any of the individual comparables. Even if Gallo were an above-average company, which it was not when ranked among the comparables, it would be unreasonable to expect Gallo to be most attractive with respect to each and every ratio. None of the 16 comparables was so positioned.

In this article we presented 16 kinds of mistakes made by valuation experts, as reported in federal courts in tax decisions. Just because one judge in one case calls something a mistake doesn't make it a mistake in all cases. But we think the above examples are indeed instructive in most valuation situations.

27 T.C.Memo 2001-75.
28 T.C. Memo 1985-363.

This article was adapted from Chapters 17-18 of *A Reviewer's Handbook to Business Valuation*, by L. Paul Hood, Jr., and Timothy R. Lee (John Wiley & Sons, New Jersey, 2011). For book details, see www.wiley.com/WileyCDA/WileyTitle/productCd-0470603402.html. VE

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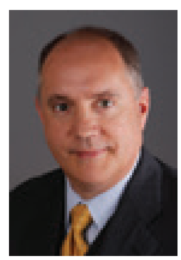

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