

Valuations Plus

Court rules appraisal must be reliable, relevant

In a case involving the donation of a conservation easement, the Tax Court ruled that the charitable contribution deduction was 100 times less than estimated by the appraiser.

Although the \$3.245 million contribution deduction was supported by an appraisal conducted by a qualified appraiser, the court refused to accept the appraisal report, calling it unreliable and irrelevant. Instead, the court accepted the appraisal conducted by the IRS's experts, which valued the charitable contribution at \$31,280. (See *Boltar LLC v. Commissioner* (136 TC No. 14, April 5, 2011).

In 2003, Boltar granted an easement to a land trust restricting the use of approximately eight acres of land in Indiana. In addition to the property that was the subject of the tax litigation, Boltar also owned a number of contiguous parcels of land, much of which was forested wetlands. The parcel affected by the easement was zoned for single-family residences.

In determining the fair market value of a qualified conservation easement, the regulations generally look to the value of comparable easements. If there are an insufficient number of comparable easements, then the regulations state that the value of the contributed easement is equal to the difference between the fair market value of the property it encumbers, before the granting of the restriction, and the fair market value of the encumbered property after the granting of the restriction.

Although, the \$3.245 million contribution deduction was supported by an appraisal conducted by a qualified appraiser, the Tax Court refused to accept the appraisal report.

In other words, when there are insufficient sales to determine the value of the easement, then a before-and-after valuation approach must be used.

Boltar engaged the services of an appraiser who valued the unencumbered property at \$3.27 million. The appraiser determined that the highest and best use for the eight acres would be a 174-unit condominium development, consisting of 29 hypothetical buildings, each containing six units. The appraiser reduced this amount by the enhancement in value of Boltar's adjacent properties as a result of the donation of the easement.

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According to the IRS, fair market value is defined as “the price at which the property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.”

But what does that mean? Fair, but in what sense of the word? Market, but in what market? Value, but on what terms? Here’s an example of how these terms work together.

Say you have a large property that you and several other persons own in a partnership. Much of the neighboring land has been converted to other uses. But your property has certain limitations and less-than-ideal features affecting its

often-onerous transferability restrictions typical of partnership agreements and their draconian consequences. Your interest cannot even be registered for public offering. So, while under fair market value, a market of hypothetical willing buyers (the partnership market) is presumed to exist, you quickly sense that the value of your limited partnership interest is significantly less than if you could sell the property outright today and collect your share of the net proceeds.

For one thing, you have to try to sell the partnership interest on your own. There is no securities firm that will help sell your unregistered interest.

Perhaps if the property is worth tens or hundreds of millions of dollars, your interest alone may be valuable enough to attract

a patient and hard-working broker intent on collecting a sizeable brokerage commission – if the broker can find a very wealthy and patient investor, that is. This particular property is not quite that large, though your interest in it is large enough to require a well-heeled buyer.

All of this will take time. And, because bank financing isn’t typically offered for partnership interests, a transaction will likely require you to offer some seller financing over a prolonged period.

Value. Will value be the face amount of the contract, once you or a broker procures a buyer

Fair market value

What does it mean?



attractiveness for conversion. The family business on the property is agricultural and intends to remain that way until the day an offer comes that the partnership “can’t refuse.”

The family business is a separately owned operation, deriving revenues from product sales and returning enough funds to cover the expenses of the land ownership of the partnership. The partnership has a corporate general partner – to prudently limit liability – and more than a dozen limited partners who have no real say in the general partner’s management of the partnership.

So, what is the fair market value of a limited partnership interest in this property-owning partnership?

Market. There is a market for real estate. Someone buying this large property could develop it, though their expectation of profit is affected by the aforementioned limitations.

Problem is, you own a partnership interest in the land, and a limited partnership interest at that. Ignore for the moment the

who will purchase your interest using your seller financing? If your seller financing is at a favorable rate of interest, will value be the present value as of the contract date of the payments due under the financing?

No. Value actually needs to factor in how long you’ll be in the market and at what reasonable rate of return you expect your investment to perform all this while.

Fair. A reasonable rate of return is the “fair” part of fair market value. If you can earn a certain return on real estate, unimpeded by limitations, you should certainly hope to earn a greater return for this more complex investment. This partnership interest presents a far greater risk to you (the seller) and to the buyer, because your flexibility to sell – and your influence on management until sale – is marginalized.

That analysis of fair market value quickly diminishes value today, even if the payoff in the future might be quite a bit more than you would receive today. – *Victor Jarosiewicz, ASA, CFA*

Matrimonial case study: The cash component of value



Our firm is a member of CPANet International, one of the nation's largest associations of CPA firms. This article was written by Laura Ewart, CPA, a member of the Litigation & Valuation Services Group with Toms River, N.J., CPANet member firm Cowan, Gunteski & Co.

A real life case can provide valuable insights into valuation issues and how to resolve them. Each case requires thoughtful analysis and the creation of a work program designed specifically for the situation at hand.

The situation

Our firm was recently retained by a wife in a matrimonial matter. Her husband owned a business in retail produce. In accordance with New Jersey case law for matrimonial cases, we typically value the business as of the date the complaint for divorce was filed. Depending on when we are brought into the case, this can mean that we are preparing reports a year or more after the complaint has been filed. This can lead to a lack of records or, at times, a lack of recollections.

Our starting point for a business valuation is the company's prior five years of tax returns and financial statements. We research the industry, acquire benchmarking and market data on the industry for comparison, and analyze the company's financial performance, as well as its assets and debt structure. These, along with our forensic analyses, help to identify, examine and, if necessary, make adjustments to the reported income stream upon which our valuation is based.



Our findings

Unreported Income – When considering an allegation of unreported income, we must look at the company's income sources and determine if there is an opportunity for this to occur. Certain industries lend themselves to a greater possibility of unreported income. If opportunity is there, it is often difficult to quantify the exact income amount.

An analysis of the company's bank records and the business owner's personal bank accounts, personal assets and lifestyle should be performed to ascertain if the reported income is consistent with these items. When confronted with the "cash" allegation, it is important to remember that, regardless of the information provided, the business owner always knows how much income their business generates.

Our investigation into this company's income sources – which were several retail produce locations – indicated the opportunity for cash income was significant. Our first step was to determine how the income reported on the tax return was calculated. We discovered the income reported was the total amount of deposits into the company checking account each year. Further analysis of the banking records for unreported income was not warranted.

Lifestyle – The husband reported a modest salary. Both parties were in their early forties, and they had three children. They agreed on the Case Information Statements that they spent approximately \$30,000 per month. Their home was appraised for about \$1.4 million, and they had two vacation homes collectively appraised at about \$1.5 million. They had no credit card debt and a single mortgage of approximately \$500,000 on all of the properties. In addition, they owned the property where the retail produce locations operated with minimal debt and had several investment accounts personally.

Debt – Often, when there is the appearance of an extravagant lifestyle and significant personal assets, there is the allegation of cash. This idea is also more prevalent when the parties seem relatively young to have acquired such assets. In most cases, there is some truth to the allegation of unreported income. Debt can be a useful tool to determine the extent or quantify the cash component. Generally speaking, a lifestyle funded by cash has little or no debt.

In this case, the personal assets acquired and the extravagant lifestyle with minimal debt indicate there is significant cash income being generated by the company.

The Estimate – How do we calculate cash income? It will always be an estimate or a range. Each case is different, and we have to use all the information we are provided, in addition to having discussions with the parties. Benchmarking data are often helpful.

As said earlier, the business owner always knows how much income is being generated. There is nearly always the proverbial "second set of books," whether it's a separate bookkeeping system or handwritten calculations.

Sometimes, you get lucky with the information you are provided. In this case, we were. The wife found a spiral-bound notebook in their home after the husband left. In this notebook was six months of his "second set of books." From this information, we calculated a range of cash income. When this was compared to the lifestyle and assets, we narrowed the range further. Inevitably, this calculation and our value led the way to a settlement in mediation.

Cash Expenses – Often, when the opportunity for unreported income is significant, the opportunity to pay expenses in cash is also significant. Most common is cash payroll or product paid in cash. It is important to include these expenses in an adjustment for unreported income.

Each case has nuances that require the keen analytical skills of the business valuation analyst. Careful planning and procedures can help assure that all the relevant data have been captured to issue a proper business valuation report. ■

Appraisal *continued from front*

The IRS's appraiser determined the highest and best use of the property was development of eight to 16 single-family homes, making the unencumbered property worth \$100,600.

The IRS argued that condominiums could not be built on the property, which was zoned for single-family homes. The IRS further argued that the hypothetical 29-building condominium project cited by Boltar's appraiser was designed for a 10-acre site, while the land that was the subject of the easement was no more than eight acres.

The IRS filed a motion to exclude the appraisal report on the basis that the report was neither reliable nor relevant.

Before the trial commenced, the IRS filed a motion to exclude Boltar's appraisal report on the basis that the

report was neither reliable nor relevant. The IRS argued that Boltar's appraiser failed to:

- Properly apply the before-and-after methodology
- Value all of Boltar's contiguous landholdings
- Take into consideration zoning restraints and density limitations
- Consider pre-existing conservation easements

As a result, the IRS contended that Boltar's appraiser valued the land by reference to a hypothetical development project that could not fit on the land, was not economically feasible to construct and would not be legally permissible to be built in the foreseeable future.

The IRS argued that Boltar's appraiser departed from the legal standard to be applied in determining the highest and best use of property and instead determined a value "based on whatever use generates the largest profit, apparently without regard to whether such use is needed or likely to be needed in the reasonably foreseeable future."

The Tax Court concluded that the valuation submitted by Boltar's appraiser was not sufficiently based on facts or data, and the report did not state the facts or data as support for the conclusions. The court found that the report was too speculative and unreliable to be useful. As a result, the court ruled that the report was inadmissible.

Without Boltar's valuation report, the court had only the report of the IRS's appraiser in evidence. Boltar offered no defense against the IRS's appraiser. As a result, the court upheld the valuation as determined by the IRS. – *Michael Redemske, CPA*

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The technical information in this newsletter is necessarily brief. No final conclusion on these topics should be drawn without further review and consultation. Please be advised that, based on current IRS rules and standards, the information contained herein is not intended to be used, nor can it be used, for the avoidance of any tax penalty assessed by the IRS.

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