What Tax Counsel Needs to Know about Working with a Valuation Specialist

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Trust and estate counsel are often involved in the planning, compliance, and controversy matters on behalf of corporate, trust, or high net worth individual clients. These taxation matters could include both (1) gift tax, estate tax, and generation-skipping transfer tax (collectively, "transfer tax") and (2) income tax matters. These transfer tax and income tax matters often involve the valuation of a private company, business ownership interest, security, or intangible asset. This discussion provides everything that trust and estate counsel need to know about selecting and working with a valuation specialist in such transfer tax or income tax matters.

Introduction

Trust and estate tax counsel ("counsel") are often involved in the valuation aspects of taxation for their corporate, individual, and trust clients.

Trust and estate counsel may become involved in these valuation considerations for tax and other estate planning, tax return compliance, audit response, tax appeal, and tax litigation purposes. For all of these purposes, counsel may have to retain, instruct, work with, rely on, and defend a valuation specialist (hereinafter "specialist") who conducts the valuation of the client's private company, business ownership interests, illiquid securities, and intangible assets.

For purposes of this discussion, these various valuation analyses are referred to collectively as "business valuations."

In these instances, counsel may need to retain the services of a specialist who performs such business valuation analyses. Depending on the particular taxation issue, counsel may retain the specialist either as a consulting expert or as a testifying expert.

Counsel may look for a specialist who has specialized experience and expertise in:

1. valuing companies in the subject industry segment,
2. conducting analyses for the specific subject purpose (e.g., the business valuation of private ownership interests for transfer tax or income tax purposes)), and
3. if relevant, providing an expert report and providing testifying expert services at a deposition, administrative appeal hearing, and/or trial.

This discussion provides practical guidance to trust and estate counsel involved in such tax planning, compliance, appeal, or litigation matters with regard to selecting and working with such a business valuation specialist.

This discussion summarizes the typical development procedures and the typical reporting procedures related to the business valuation of the subject company business ownership interest securities, or intangible assets. And, this discussion summarizes the professional standards and the professional practices that such a specialist typically follows in the business valuation process.

In other words, this discussion summarizes what trust and estate counsel needs to know to retain and to work with a valuation specialist for tax planning, compliance, appeal, or litigation purposes.

The Business Valuation

For purposes of this discussion, the valuation subject in the taxation matter may include any private business, business ownership interest, security, or intangible asset.

Such a business interest could include a C corporation, S corporation, limited liability company ("LLC"), partnership, sole proprietorship, or any other tax or legal business form.

The business ownership interest could include the subject entity, a joint venture, a franchise agreement, or any other contractual agreement or contract right related to the subject entity. And, the ownership interest could include a fee simple interest (or total ownership interest) or a limited or partial ownership interest—such as a term interest or a reversionary interest.

The security could include common stock, preferred stock, a partnership interest, LLC member units, or other equity interest. The equity ownership interest could be controlling ownership interest or a noncontrolling ownership interest. The equity interests could enjoy voting rights—or not.

The equity interest could be marketable, nonmarketable, or subject to various types of contractual transferability restrictions. In fact, the equity interest could be subject to the terms of a shareholder agreement, partnership agreements LLC membership agreement, or other contractual agreement.

The security could also include secured and unsecured debt instruments. The security could include convertible debt instruments. And, the security could include options, warrants, grants, and other contract rights.

The intangible asset could include intellectual property, other identifiable intangible assets, intangible value in the nature of goodwill, or any type of license or contract rights or provisions related to such intangible assets.

And, any of these ownership interests could be included in a trust, a pension plan, or some other special ownership instrument or mechanism.

Any of the above intangible property interests may be the subject of a "business valuation" for transfer tax or income tax purposes.

There are generally accepted business and security valuation approaches and methods. And, there are generally accepted intangible asset valuation approaches and methods.

There are conceptual similarities between these two sets of valuation approaches and methods. With regard to the individual analytical procedures and individual valuation variables, there are subtle—but important—differences between these two sets of valuation approaches and methods.

The specialist's familiarity with business valuation—and with intangible asset valuation—approaches and methods is discussed below. Otherwise, a detailed discussion of these two sets of valuation approaches and methods is beyond the scope of this discussion.

Selecting the Valuation Specialist

Trust and estate counsel should exercise due diligence in selecting the specialist. Some of the counsel's selection criteria may include the following:

1. The institutional qualifications (including experience and expertise) of the specialist's firm
2. The professional qualifications (including experience and expertise) of the individual specialist
3. Any prior relationships of the specialist with the taxpayer (and/or the subject company)

Considerations regarding the Specialist's Firm

There are many types of professional service firms that provide valuation services, including public accounting firms, industry specialist consulting firms, valuation groups within general financial advisory services firms, business valuation firms, real estate and other property appraisal firms, forensic analysis firms, economic consulting firms, and many others.

Some of these firms are very small, including sole practitioners and small professional practices. Some of these firms are quite large, with dozens of offices and hundreds of practitioners.

Some firms specialize in the valuation analysis of (1) certain types of businesses (including industrial or commercial companies or professional services firms) or of (2) certain types of business ownership interests (including restricted public securities or intellectual property).

Some firms specialize in the analysis of certain industries or industry segments (including public utilities, regulated industry companies, energy companies, construction industry companies, transportation companies, health care companies, legal or accounting practices, engineering companies, etc.).

Some firms specialize in the development of business, security, and/or intangible asset valuations prepared for specific purposes (including valuations for financing, bankruptcy, gift and estate tax, income tax, property tax, financial accounting, condemnation and eminent domain, or other purposes).

Some firms specialize in controversy-related valuation analyses. These firms primarily specialize in providing valuation-related consulting expert services and testifying expert services. Such controversies could include tort disputes, breach of contract disputes, taxation matters, family law matters, eminent domain matters, and others.

In addition, some valuation firms are deliberately generalist firms. These firms perform both business and property valuations. These firms may practice across many industries and many industry segments. And, these firms may provide valuation services for transaction, financing, taxation, financial accounting, corporate planning, litigation, and many other purposes.

The institutional qualifications of each valuation firm can be demonstrated in different ways. Some counsel may prefer firms that specialize in conducting valuations for a specific purpose (e.g., transfer tax, income tax, property taxation). Other counsel may prefer firms that are more generalist in nature—that is, firms that do not focus exclusively on engagements for taxation or for any particular purpose.

Nonetheless, the selected firm should be able to demonstrate its professional experience related to:

1. conducting business valuation analyses for the subject transfer tax and income tax planning, compliance, appeal, or litigation purpose and
2. conducting business valuation analyses that can withstand a contrarian review (e.g., an Internal Revenue Service examiner's scrutiny, an Internal Revenue Service appeals division review, tax litigation cross examination).

Counsel may be particularly interested in the firm's valuation experience:

1. in the subject company's or the subject security's industry segment and
2. in the subject taxpayer's valuation issue (e.g., a charitable contribution of LLC membership interests or the gift of a nonmarketable, noncontrolling ownership interest in S corporation common stock).

Important Issues in the Valuation

There are relatively few areas that distinguish business valuations prepared for one purpose from business valuations prepared for another purpose. However, the selected valuation firm—and the selected valuation specialist—should be familiar with such differences.

For example, the following issues may be important in the business valuation prepared for transfer tax or income tax purposes:

1. The transfer tax and income tax valuation sometimes includes elements of both a business valuation and an intangible asset valuation (either separately or as a component of the business valuation). Accordingly, the specialist should be familiar with both generally accepted business valuation principles and generally accepted intangible asset valuation principles.
2. The specialist should be familiar with the professional standards and the professional practices related to both business valuation and intangible asset valuation.
3. Regardless of what business interests (business, business ownership interest, security, or intangible asset) are included in the transfer or other taxable transaction, only the property interests subject to taxation should be included in the valuation. So, the specialist has to be able to identify and to appraise only those value elements (e.g., including control elements, marketability elements, ownership rights, contractual provisions) that should be included in the taxable event.
4. The appropriate standard of value and the appropriate premise of value should be based on the purpose of the valuation analysis; that is, the valuation standard and the valuation premise should be appropriate to the tax-related statutory authority, administrative rulings, and judicial precedent. While some intercompany transfer pricing analyses should conclude the arm's-length

price standard, the appropriate valuation standard for most transfer tax and income tax valuations is fair market value.

5. The identification and the valuation of any business owner or personal intangible value in the nature of goodwill—as compared to business or institutional intangible value in the nature of goodwill—should be considered and, if appropriate, subtracted from the private company business value.
6. The measurement of (and the reasons for) any value appreciation (or value depreciation) between two dates (e.g., the entity purchase or creation date and the current transfer date) may be relevant.
7. The amount of (and the reason for) any extraordinary (i.e., above the industry average) appreciation in the private company, business ownership interest, security, or intangible asset value during a specific time period may be examined.
8. The valuation of the subject company on multiple dates (e.g., an event that could cause the recognition of a worthless stock deduction) may be considered.
9. The use of forensic accounting procedures—to identify unreported assets, unrecorded liabilities, and to conduct due diligence management interviews—may be appropriate.
10. The identification and quantification of any valuation adjustments (i.e., valuation discounts and premiums) related to lack of marketability, the lack of control, or the lack of voting rights or other ownership rights may be appropriate when capital market pricing data or other data are used to value the subject private company or security.
11. The identification and quantification of any buyer-specific synergistic or strategic value increments that may be considered when merger and acquisition transaction pricing data are applied to value the subject private company or security.
12. The identification and consideration of any company-specific, security-specific, or intangible-asset-specific risk premiums may be appropriate in the specialist's development of the business valuation yield capitalization rate or direct capitalization rate.

Considerations regarding the Valuation Specialist

The professional qualifications of the individual valuation specialist are also important. The specialist may provide consulting expert services to counsel. And, the specialist may also provide testifying expert services to counsel. In addition, the specialist may also provide audit support and other litigation support services.

Accordingly, the professional qualifications of the individual specialist should be able to:

1. impress an Internal Revenue Service examination agent, an Internal Revenue Service appeals division hearing officer, or a judicial finder of fact and
2. withstand a rigorous contrarian scrutiny (from, say, the Internal Revenue Service legal counsel).

While assessing the professional qualifications of the individual specialist, counsel may inquire about that specialist's personal experience in conducting valuations:

1. related to a transfer tax or an income-tax-related issue,
2. of the type of business ownership interest, security, or intangible asset owned by the taxpayer,
3. in the subject company's industry segment, and
4. within an audit, appeal, litigation, or other contrarian environment.

In terms of education, many specialists have formal education in finance, accounting, and/or economics. In the same respect, many (but not all) specialists hold one or more professional valuation credentials granted by a recognized valuation professional organization ("VPO").

There is no statutory, judicial, or regulatory requirement that a specialist hold any particular valuation-related professional credential. Many industry consultants, economists, college professors, forensic accountants, real estate appraisers, business valuation analysts, and other types of professionals provide valuation services—without having earned a valuation-related professional credential.

However, counsel should be aware that the subject taxation matter may require a "qualified appraiser" to perform a "qualified appraisal." That is, the selected specialist may need sufficient qualifications in order to be accepted as a "qualified appraiser." And, the specialist's work product may need to be accepted as a "qualified appraisal."

In addition, counsel should be aware that there are VPOs that offer valuation-related training, examination, credentialing, and continuing education programs. There are business valuation professional credentials, and there are property appraisal professional credentials. Both sets of professional credentials may be relevant to the subject taxation-related valuation assignment.

Some of these professional credentials—and the related VPOs—in the business valuation discipline include the following:

1. The accredited in business valuation ("ABV") credential is granted by the American Institute of Certified Public Accountants ("AICPA")
2. The accredited senior appraiser ("ASA") business valuation credential is granted by the American Society of Appraisers
3. The certified business appraiser ("CBA") credential was previously granted by the Institute of Business Appraisers ("IBA") (see explanation below)
4. The certified valuation specialist ("CVA") credential is granted by the National Association of Certified Valuators and Valuation specialists ("NACVA")

In 2008, the IBA merged into NACVA. While NACVA no longer grants the CBA credential to new candidates, it does support and maintain the CBA program for the current CBA credential holders.

Counsel—and the specialist—may need to rely on real property, personal property, and other property appraisers within the context of developing the business valuation. In addition, the subject private company may own excess, investment, or other nonoperating property that may best be appraised by a property appraiser.

Some of the professional credentials—and the related VPOs—in the property appraisal discipline include the following:

1. The Appraisal Institute grants the MAI credential and other real estate appraisal credentials
2. The American Society of Appraisers grants appraisal credentials in real estate appraisal, machinery and technical services appraisal, and other property appraisal disciplines

Each of these VPOs has developed its own set of requirements in order for a candidate to earn its professional credential. Generally, each of the VPO credentialing requirements include college education, a minimum amount of practical valuation experience, attendance at technical courses and specialized training programs, reviews of demonstration valuation reports, recommendations of current credentialed members, and the passing of a comprehensive technical examination.

In addition, each of the VPOs has ongoing ethical standards compliance requirements and continuing professional education requirements.

Counsel should consider that the subject tax-related valuation assignment may include elements of both business valuation and property appraisal. Therefore, counsel may need to retain both business valuation analysts and property appraisers as part of the valuation specialist team.

In addition to the above-mentioned VPO credentials, many business valuation specialists are either certified public accountants ("CPAs") or chartered financial analysts ("CFAs").

The CPA credential involves a uniform national examination and state-specific accountancy licensing requirements. Many CPAs are (but are not required to be) members of the AICPA. The CFA credential is granted by the Chartered Financial Analyst Institute ("CFAI").

Each of the business-valuation-related VPOs (i.e., AICPA, ASA, IBA, and NACVA) has promulgated its own set of professional standards. (In 2008, the IBA professional standards were conformed to—and then merged into—the NACVA professional standards.)

The most voluminous of the various set of business valuation professional standards is the AICPA *Statement on Standards for Valuation Services* ("SSVS"). The title of SSVS is Valuation of Businesses, Business Ownership Interests, Securities, and Intangible Assets.

Unrelated to any of the above-mentioned VPOs, the Appraisal Standards Board of the Appraisal Foundation promulgates the *Uniform Standards of Professional Appraisal Practice* ("USPAP").

The USPAP standards 1 and 2 relate to the development and the reporting (respectively) of real property appraisals.

The USPAP standards 3 and 4 relate to the development and the reporting of appraisal reviews.

The USPAP standards 5 and 6 relate to the development and the reporting (respectively) of mass appraisals.

The USPAP standards 7 and 8 relate to the development and the reporting (respectively) of personal property appraisals.

And, the USPAP standards 9 and 10 relate to the development of and the reporting of (respectively) a business valuation or an intangible asset valuation.

The subject business valuation may involve consideration of the value of all of the taxpayer's real property, tangible personal property, and intangible personal property. Therefore, the selected valuation specialist should be familiar with all of the above-listed components of USPAP.

Prior Relationship of the Valuation Specialist and the Taxpayer or the Subject Company

Counsel may also inquire about independence issues when retaining the valuation firm or the individual valuation specialist. There may be a concern if the valuation firm works regularly for the subject taxpayer or the subject company.

That association may present the appearance of a bias. That is, the selected specialist should be independent—and appear independent—with regard to the subject taxpayer and the subject company.

In addition, many valuations performed for financing, transaction, accounting, or litigation purposes require the specialist to be independent of the subject company. The appearance of independence could be questioned if the specialist is frequently retained by the subject taxpayer or by the subject company.

Reviewing the Valuation Report

The first step in counsel's review of—and dependence on—the specialist's valuation report is to become familiar with the business valuation process. Counsel should understand the level of due diligence and analysis that will be conducted by the specialist in order to reach the business valuation conclusion.

For example, counsel may be interested in whether the specialist plans to interview the private company management—or other parties—during the course of the business valuation. These interviews may be conducted in order to:

1. understand the nature and history of the subject company business operations and
2. discuss the historical and prospective performance (financial and operational) of the subject company business operations.

If all parties agree, counsel may arrange for these interviews to take place in person at the private company's facilities. This arrangement may provide the valuation specialist with the opportunity to tour the company's facilities and to view the physical condition of the company's tangible assets.

If the parties agree to the interviews, the interview process may also allow the specialist to gain a better understanding of the company's (1) services, (2) strategic plan, (3) competitors, and (4) competitive position in the market.

As mentioned above, there are generally accepted business valuation approaches and methods. The specialist typically considers each of these generally accepted business valuation approaches and methods:

<u>Income approach</u>

- Discounted cash flow method
- Direct capitalization method

<u>Market approach</u>

- Guideline publicly traded company method
- Guideline merger or acquisition transactions method
- Backsolve method

<u>Asset-based approach</u>

- Adjusted net asset value method
- Asset accumulation method

As mentioned above, there are also generally accepted intangible asset valuation approaches and methods. The specialist typically considers each of these generally accepted intangible asset valuation approaches and methods:

<u>Income approach</u>

- Multiperiod excess earnings method
- Capitalized excess earnings method
- Profit split (or residual profit split) method
- Incremental income method
- Differential income method

<u>Market approach</u>

- Sales comparison method
- Relief from royalty method
- Comparable profit margin method

<u>Cost approach</u>

- Trended historical cost less deprecation method
- Replacement cost new less deprecation method
- Reproduction cost new less deprecation method

The specialist will typically consider all business valuation methods and/or all intangible asset valuation methods. And, the specialist will typically apply:

1. each valuation method for which there is a sufficient quantity and quality of data and
2. each valuation method that is applicable to develop a credible valuation of the subject business, security, or intangible asset.

The specialist typically reconciles and synthesizes the value indications from each applicable method in order to conclude a final value opinion for the subject business, security, or intangible asset.

The business valuation analysis may be documented with a narrative valuation report. As stated above, each of the VPOs has issued professional standards with regard to valuation reporting. The following sections provide a summary of the typical contents of such a business valuation report.

Description of the Taxpayer's Subject Ownership Interest

The valuation report should adequately describe the ownership interest subject to valuation. Typically, this description typically includes the following:

1. The name of the subject company
2. The form of the subject entity legal ownership
3. The entity that owns the valuation subject (if the subject is an intangible asset or a subsidiary or other business unit of a parent corporation)
4. The types of securities included in the valuation analysis
5. The level of ownership interest (or the level of control, marketability, and other ownership interest elements)

For example, a description of the valuation subject may read as follows:

> We estimated the fair market value of 1,000 nonvoting membership units ("the subject units") of the Interstate Pipeline LLC ("IP"). IP is a wholly owned subsidiary of International Pipelines Corporation. We estimated the fair market value of the subject units on a nonmarketable, noncontrolling ownership interest basis.

The above description informs the valuation report reader as to:

1. the name of the company subject to the valuation,
2. the securities subject to valuation, and
3. the bundle of property rights included in the value conclusion.

Standard of Value and Premise of Value

The valuation report should describe the standard of value (or definition of value) that is concluded in the analysis. Most transfer tax and income-tax-related valuations typically apply the fair market value standard of value and a premise of value that concludes the highest and best use of the subject business, security, or intangible asset.

Generally, specialists apply the definition of fair market value that is included in Internal Revenue Service Revenue Ruling 59-60. Fair market value is generally defined to be the price at which the property would change hands between a willing buyer and a willing seller, when neither is under any compulsion to buy or to sell, and with both parties having reasonable knowledge of the relevant facts.

Some specialists expand this definition to add that the buyers and sellers are hypothetical buyers and sellers—as opposed to a specific buyer and/or seller. Nevertheless, the important elements of the definition remain the same. That is, an unrelated buyer and seller are coming together to conduct a transaction when neither is being forced to buy or sell and both parties are aware of all relevant information concerning the subject ownership interest.

The valuation report should also describe the premise of value—that is, the valuation report should explain whether the valuation subject was valued based on the premise of:

1. value in use—as part of a going-concern premise of value—or
2. value in exchange—as part of an orderly disposition of individual assets premise of value.

If the valuation specialist did not value the subject business interest based on the premise of value in use as a going concern, then the valuation report should discuss the rationale for conducting the valuation based on an alternative premise of value.

Purpose of the Analysis

The valuation report should describe the purpose of the analysis. Typically, the purpose of the valuation report is to provide information to the parties involved in the subject transfer tax or income tax matter.

The valuation report should describe the purpose of the analysis so there is no confusion over the intended use of the report.

Valuation Date and Report Date

The valuation report should indicate (1) the valuation date and (2) the report date. The valuation date is the "as of" date on which the specialist's value opinion applies. The report date is the date on which the specialist's valuation report was signed and issued.

For example, the valuation report may estimate the fair market value of the total common equity of Illustrative Company as of January 1, 2020. However, the valuation report may not be prepared until April 15, 2020. In this case, the valuation date is January 1, 2020, and the report date is April 15, 2020.

In this example, counsel should understand that the valuation opinion takes into account all known and knowable information available through January 1, 2020. Under the fair market value standard of value, the valuation report typically does not consider any information that became available, or known, subsequent to the valuation date.

Level of Value and Prerogatives of Ownership Control

In a business valuation, the specialist typically (but not always) concludes a fee simple ownership interest in the subject company securities, or intangible asset. If the valuation subject is something other than a fee simple ownership interest, that fact should be clearly disclosed.

The specialist needs to consider the control elements associated with the valuation subject. That is, the specialist either values the subject interest on a controlling ownership interest basis or a noncontrolling ownership interest basis.

Likewise, the specialist needs to consider the marketability elements associated with the valuation subject. That is, the specialist either values the subject ownership interest on a marketable interest basis or on a nonmarketable interest basis.

The valuation report typically identifies the subject property and describes the prerogatives of ownership control and the marketability (or lack thereof) characterizations that accompany the ownership interest.

The valuation report will often:

1. identify the specific control attributes and marketability attributes associated with the subject business, security, or intangible asset and
2. explain how these control attributes and marketability attributes were considered in the business valuation process.

Sources of Information

The business valuation report typically includes a section that lists the data and the documents that the specialist relied on to develop the value opinion.

By reviewing this section of the valuation report, counsel should develop an understanding of both (1) the publicly available documents and (2) the non-publicly-available documents that the specialist considered in the valuation process.

The sources of information list should include the financial-related documents used in the valuation analysis (e.g., financial statements, empirical market data), and the non-financial-related documents (e.g., client or supplier contracts, leases, licenses, corporation documents).

The sources of information list should enable the report reader to identify the documents necessary to replicate the valuation analysis.

Description of the Subject Company

The valuation report should provide an adequate description for the reader to understand the fundamental position of the subject company, or security, or intangible asset.

The valuation description of the subject company subject or of the subject intangible asset typically includes the following:

- A discussion of the history of the subject company and its current position
- A description of the goods or services provided by the subject company
- A description of the markets served by the subject company
- A description of the competitive environment in which the subject company operates and how the company is positioned within that competitive environment (i.e., the company's market position)
- A discussion of the principal facilities or other properties owned or operated by the company
- A discussion of the company's significant relationships with related parties, clients, suppliers, and so on
- A discussion of any pending litigation or regulatory issues that are significant to the company
- A review of recent transactions (if any) in the company or its securities or its intangible assets
- A discussion of any recent offers received for the company, or its securities or its intangible assets

Overview of General Economic Conditions and Industry Conditions

The valuation report should provide the reader with an overview of the general economic conditions and industry-specific factors that affect the valuation of the subject company.

The economic overview may include a discussion of trends in economic growth, inflation, consumer spending, consumer confidence, interest rates, construction starts, and business spending. In each case, the analysis should be tailored to the economic factors that most directly affect the subject company. This valuation report section may also include a discussion of economic indicators that provide insight into the future performance of the subject company.

The industry overview report section typically describes:

1. how the company's industry operates and
2. recent trends affecting companies within the company's industry segment.

This report section may also describe:

1. the subject company's position in its industry segment and
2. the subject company's market share relative to other competing companies.

Subject Company Financial Performance

As part of the valuation process, the specialist assesses the financial performance and financial condition of the subject company. A summary of this financial analysis typically appears in the valuation report.

The subject company's historical financial performance is reflected on the company's income statements and cash flow statements. The valuation report may include a discussion of the following:

- The historical growth or decline in revenue
- The historical growth or decrease in aggregate profitability (i.e., gross profit, operating profit, pretax profit, and net profit)
- The historical growth or decrease in profit margins
- The historical growth or decrease in cash flow
- The historical payments of dividends

The specialist also reviews the company's balance sheet to assess the company's financial condition. The valuation report may contain a discussion of the following balance-sheet-related items:

- The company's liquidity and working capital position
- The company's asset utilization by means of various financial or operational ratios (e.g., accounts receivable turnover, inventory turnover, etc.)
- The company's tangible property base
- The company's capital structure and leverage
- The net book value of the company (as required in Revenue Ruling 59-60)

This financial analysis may include a discussion of significant financial statement trends and a discussion of what factors caused the respective trends.

The valuation report may also include a discussion of how the subject company performs relative to other companies in the company's industry segment. This comparative financial analysis typically identifies the financial strengths and weaknesses of the company compared to other guideline/competing companies.

The comparative financial analysis should help the report reader to understand how the subject company performs relative to other companies in the industry segment. This comparative performance analysis may be based on such factors as size, growth, profitability, and volatility.

Financial Statement Normalization Adjustments

When appropriate, the specialist may make normalization adjustments (1) to the subject company's financial statements and (2) to selected guideline publicly traded companies' financial statements.

The financial statement normalization adjustments may be necessary in order to present the financial performance of the subject company on the same basis as the financial performance of the selected guideline companies.

The following list includes some of the financial statement adjustments that the specialist may consider:

- Adjustments for extraordinary or nonrecurring income and expense items
- Adjustments for differences in inventory (and other) accounting methods
- Adjustments for nonoperating income and expense items
- Adjustments for non-arm's-length transactions/arrangements
- Adjustments for excess compensation or other benefit expense

The valuation report should identify any financial statement adjustments and explain the rationale for each adjustment.

Generally Accepted Valuation Approaches and Methods

As mentioned above, there are three generally accepted business valuation approaches: the market approach, the income approach, and the asset-based approach.

And, there are three generally accepted intangible asset valuation approaches: the market approach, the income approach, and the cost approach.

A detailed discussion of the generally accepted valuation approaches is beyond the scope of this discussion.

The valuation report should describe which business or intangible asset valuation approaches—and which valuation methods within each approach—the specialist applied in the valuation analysis. In the same respect, the valuation report should explain which business or intangible asset valuation approaches were not applied in the valuation analysis—and why the specialist did not apply them.

With regard to the business valuation market approach, and specifically the guideline publicly traded company method and the guideline merger and acquisition ("M&A") transactions method, the valuation report should include the following:

- The criteria the specialist applied to select the guideline public companies and the guideline M&A transactions. The selection criteria may include standard industrial classification code, business description, location, size, growth rate, profitability metrics, return on investment metrics, or a combination of several relevant factors.
- A description of each selected guideline publicly traded company and guideline M&A transaction. This description may include a discussion of each selected guideline company's (or guideline transactions) business, its location, its products and/or services, and its position in the market.

  Other information, such as whether the guideline publicly traded company recently completed acquisitions, may also be relevant.
- The market-derived pricing multiples that the specialist selected for the business valuation. These pricing multiples may include invested capital (i.e., total long-term debt plus total equity) pricing multiples, equity pricing multiples, or asset pricing multiples. Industry-specific factors often influence the type of market pricing multiples that the specialist applies in the valuation analysis.

  For example, the valuation of an electric generation company may involve the application of market-derived pricing multiples that are based on (1) the company's revenue generation, (2) the company's electric generation capacity, or (3) the company's average actual electric generation during a recent time period.

In contrast, the valuation of a hospital or nursing home company may involve the application of market-derived pricing multiples that are based on (1) the number of licensed beds in the facility or (2) the average actual utilization (occupancy) of the number of licensed beds during a recent time period.

As a further example, the valuation of a railroad or an airline may involve the application of market-derived pricing multiples that are based on (1) revenue generation; (2) earnings before interest, taxes, depreciation, and amortization (or EBITDA); or (3) net cash flow.

- The rationale for selecting the market-derived invested capital pricing multiples that the specialist applied to the subject company's financial fundamentals. The valuation report reader should be able to understand the specialist's thought process for arriving at the selected valuation pricing multiples.

  The application of an average or a median market-derived pricing multiple, with no support for such a selection, is typically not appropriate.

  Rather, subject-specific pricing multiples are typically based on the specialist's comparison of the subject company to the market-derived guideline companies or to the guideline transactions in terms of (1) size, (2) growth rates, (3) profit margins, and (4) returns on investment.

- The rationale for the selected weighting the specialist applied in the valuation synthesis.

  For example, if the business value indication based on a multiple of projected net cash flow is assigned more (or less) weight than the business value indication based on a multiple of trailing 12-month net cash flow, then the valuation report should explain why the specialist assigned that relative weighting.

With regard to the business valuation income approach, and specifically the discounted cash flow method, the valuation report should include the following:

- A discussion of who prepared the financial projections that are incorporated in the unit valuation. The financial projections are often prepared by the subject company management. In other cases, the financial projections may be prepared by the specialist with input from the subject company management.

  In the case of management-prepared financial projections, the valuation report may explain how the specialist tested the reasonableness of these financial projections. In all cases, the company's financial projections relied on in the valuation income approach analysis should be supported and supportable.

- A discussion of the appropriate matching of the financial projections and the present value discount rate. For example, if the discounted cash flow method incorporates a projection of net cash flow to invested capital (i.e., to the subject company's total long-term debt plus total equity), then the present value discount rate should be the weighted average cost of capital.

  If the cash flow projection is developed on a pretax basis, then the applicable present value discount rate should be developed on a pretax basis. If the cash flow projection is developed on an after-tax basis, then the applicable present value discount rate should be developed on an after-tax basis.

  That is, both the income projection and the present value discount rate (or the direct capitalization rate) should be developed based on the same:

  1. level of ownership interest (e.g., total equity versus total invested capital) considered in the analysis and

  2. level of income taxation applied in the analysis.

- A discussion of the cost of capital components. This discussion may include an

explanation of how the specialist estimated the cost of equity capital, the cost of debt capital, and the weighting of each of the capital components in the weighted average cost of capital calculation.

- Support for any selected residual value (also sometimes called terminal value) pricing multiple or residual value direct capitalization rate. In many business valuations, the residual value may represent a significant portion of the total business value.

  As a result, the selected residual value pricing multiple, or the residual value direct capitalization rate, often has a material effect on the business value conclusion. The specialist's rationale for the selected residual value pricing multiple, or the selected long-term growth rate component of the residual value direct capitalization rate, should be adequately explained and supported in the valuation report.

For an intangible asset valuation, the generally accepted cost approach valuation methods include the trended historical cost less depreciation ("THCLD") method, the replacement cost new less depreciation ("RCNLD") method, and the reproduction cost new less depreciation ("RPCNLD") method.

All of these cost approach methods have two elements in common:

1. They apply a comprehensive definition of cost—that is, the selected cost metric includes all applicable cost components.
2. They include a comprehensive definition of depreciation—that is, the depreciation metric includes all depreciation and obsolescence components.

Counsel (and the specialist) should also be aware that it is possible to apply the cost approach to value all of the subject company's asset categories, including the following:

1. Working capital accounts
2. Real estate
3. Tangible personal property
4. Intangible personal property
5. Intangible value in the nature of goodwill

Counsel (and the specialist) should be aware that the cost approach depreciation analysis should include all types of property depreciation categories:

1. Physical depreciation
2. Functional obsolescence
3. Economic obsolescence

Financial accounting (or "book") depreciation typically encompasses the following:

1. Physical depreciation
2. Some components of functional obsolescence

Financial accounting depreciation does not include:

1. all components of functional obsolescence or
2. any economic obsolescence.

These depreciation components should have been separately identified and separately measured in the application of the cost approach in a tangible asset valuation.

Counsel (and the specialist) should be aware that the cost approach may be applied to estimate the going-concern value of the assets—tangible and intangible—of the subject company.

That is, the cost approach (unless specifically applied to conclude such a value) does not conclude the liquidation value of the assets—tangible and intangible—of the going-concern subject company. Rather, the cost approach typically concludes the going-concern value of the subject company's property categories.

Valuation Synthesis and Conclusion

The valuation report should contain a section that provides the following:

1. A valuation synthesis of the alternative unit value indications
2. A final value conclusion for the subject business, business ownership interest, security, or intangible asset

The following factors are typically included in this valuation report section:

- A discussion of how each value indication from each valuation approach and method was weighted in the final value conclusion. An explanation should be provided for each of the selected value indication weightings.
- A discussion of any valuation adjustments—i.e., valuation premiums or discounts—that may be appropriate to reflect the elements of ownership control and marketability

related to the subject business ownership interest or security.

The discussion of the application of valuation adjustments may include:

1. the specialist's rationale for any valuation premium or valuation discount applied and
2. the supporting data or factors that the specialist considered in order to select any applicable valuation premium or valuation discount.

The valuation report should explain how the specialist reconciled and synthesized each value indication in order to reach a final value conclusion. The valuation report should provide sufficient information to allow the report reader—and the counsel—to recreate the specialist's thought process and to replicate the specialist's mathematical procedure to reach the final value conclusion.

After reviewing the valuation report, the counsel—or any other report reader—should be able to understand the following issues:

- Was the valuation report readable and easy to understand? Or, was it filled with undefined valuation terms and jargon?
- Was the valuation report comprehensive and organized in a logical manner?
- If more than one valuation date is considered, has the concluded value changed over time, and if so, what were the primary drivers of this change in value (i.e., the subject company's performance, the subject industry or market condition performance, or a combination of the two)?
- Has the subject company's financial performance improved or deteriorated over time, and has the concluded value changed accordingly?
- Which generally accepted business or intangible asset principle valuation approaches and methods were applied in the analysis? And, why were they applied?
- Does the value conclusion seem reasonable given (1) the historical and projected financial performance of the subject company, (2) the relevant market-based data, and (3) the relevant general economic conditions and industry-specific conditions?
- Does the value conclusion appropriately reflect the relevant standard of value, premise of value, and other property-specific factors and/or legal instructions?

Summary and Conclusion

> **"The valuation report should provide sufficient information to allow the report reader . . . to recreate the specialist's thought process and to replicate the specialist's mathematical procedure to reach the final value conclusion."**

Trust and estate counsel are often involved with the valuation aspects of transfer tax and income tax. These issues may involve tax planning, compliance, appeal, or litigation. In such taxation matters, counsel often have to retain, instruct, work with, rely on, and defend a valuation specialist.

In such instances, counsel have to select a specialist with the appropriate credentials, experience, and expertise to value the subject business, business ownership interest, security, or intangible asset.

This discussion summarized some of the issues that trust and estate counsel may consider in the selection of such a specialist. Such a specialist may assist the tax counsel as a consulting expert or as a testifying expert.

In addition, this discussion summarized the development procedures and the reporting procedures related to the tax-related valuation of the subject business, business ownership interest, security, or intangible asset.

Trust and estate counsel should be generally aware of the professional standards and the professional practices related to the development of—and the reporting of—the business or intangible asset valuation. This is because, in addition to retaining the valuation specialist, counsel may have to work with, rely on, and defend the selected specialist during the tax audit, appeals division conference, or litigation.

This discussion summarized what trust and estate counsel need to know about working with a valuation specialist in the development of, and the defense of, a business valuation or intangible asset valuation for transfer tax or income tax purposes.

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