Valuation: Living with uncertainties in changing markets

The current 2010 economy has transformed valuation of property for tax purposes into an increasingly complex area and, at the same time, one that is increasingly critical.

Over the past few months, the Internal Revenue Service has issued guidance on various fronts that brings potential relief to a number of tax strategies dependent upon accurate valuation. Yet the IRS is also stepping up enforcement of existing valuation guidelines in other areas. The biggest challenge appears to be not in adjusting to these developments, but rather in the difficulties presented in properly valuing assets whose price literally can vary overnight.

- **Valuation for OICs.** Valuation of residential real property for IRS collection purposes has become a hot issue, reaching all the way up to the commissioner's office. On the one hand, a homeowner wants to value a property low to discourage the IRS from a foreclosure action. If a property's fair market value cannot even support a payoff of the existing mortgage on the residence, the IRS usually has no benefit in forcing a foreclosure.

On the other hand, when the valuation of a residence is low, taxpayers have been finding that they may have too little equity to qualify for an offer in compromise ("OIC"). In most cases, the IRS will not accept an OIC unless the amount offered by the taxpayer is equal to or greater than the reasonable collection potential ("RCP"). The RCP is how the IRS measures the taxpayer's ability to pay, and includes the value that can be realized from the taxpayer's assets, with real property often the most significant.

The IRS Commissioner recently commented that a major reason why there have been fewer offers in compromise lately is that home equity has declined so significantly. Rather than assume that initial valuations are correct in denying an OIC, however, the Commissioner has ordered internal procedures that give real estate valuation a second look in these OIC situations. In implementing that directive, Small Business/Self-Employed Division interim guidance recognized that "during these current economic times, the value of real property may be difficult to determine."

➢ **Asset smoothing.** "Asset smoothing" for minimum funding requirements averages the fair market value of assets on a qualified retirement plan's current determination date (generally January 10 and the "adjusted" fair market value of the assets on one or more prior valuation dates. Under proposed regs, adjusted fair market value included increases for contributions after the valuation date and decreases for benefits paid.

The proposed regs, however, did not adjust fair market value for expected earnings (or the lack of earnings, in the present environment). In 2008 legislation, Congress directed the IRS to allow more generous asset smoothing. IRS Notice 2009-22 makes good on that responsibility, setting up procedures to allow employer to factor in expected earnings when determining total asset value.

➢ **Separate value to trademark/trade names.** The IRS chief counsel in CCA 200911006 earlier in 2009 announced a reversal in policy regarding the like-kind exchanges of trademarks, trade names, mastheads and customer-based intangibles. When these intangible items can be separately described and valued apart from goodwill, they will now qualify as like-kind property under Code Section. 1031. The IRS had viewed trademarks and trade names as an inseparable component of a larger asset, either of goodwill or of a going concern. This had been the IRS position even though many experts read Newark Morning Ledger Co. v. U.S., 507 U.S. 546, to suggest otherwise. Chief counsel now concedes that "except in rare and unusual situations," intangibles such as trademarks, trade names and mastheads can be separately described and valued apart from goodwill.

➢ **Roth annuity conversions.** Recent final regulations (TD 9418) on converting a non-Roth IRA annuity to a Roth IRA provide for three different methods of determining the fair market value of the annuities: the traditional comparable contract method; an approximation method; and a premium accumulations method. This relief is particularly important after 2009 when there will be no adjusted gross income limit to conversions and, for 2010, the conversion may be averaged over the next two years.

- **Rolling-average inventory method.** In a significant change, the IRS announced in late 2007 that a rolling-average method used to value inventories for financial accounting can "clearly reflect income" for federal income tax purposes. The approval is conditioned on the use of one of two safe harbors described in Rev. Proc. 2008-43. The IRS has viewed the use of the rolling-average inventory valuation method (also called the average cost method) as an impermissible method, which did not clearly reflect income, especially when inventory was held for several years or costs fluctuate substantially. Now, the IRS will generally accept the rolling-average method for taxpayers who use the method for financial accounting purposes.

- **Suspicious eye toward donations.** Despite the economic slowdown, charitable organizations "should not take more aggressive postures to solicit donations," officials at the IRS Tax Exempt and Government Entities Division have stated. In particular, the IRS warned that it will be watching for fundraising and valuation abuses.

- **Family attribution proposal.** A bill before Congress, HR 43, would require family attribution in the valuation of any minority holding. The lack of marketability discount would significantly impact estate planning for family-controlled businesses.

- **Schedule M-3 reconciliations.** The advent of International Financial Reporting Standards and its differences from U.S. GAAP are raising valuation issues, not only for inventory and LIFO accounting but also for valuation in mark-to-market rules under Code Sec. 475. Likewise, FASB's fair value accounting standards are showing strain, generating calls for clarification of the application of FAS 157 on stressed markets.

- **Façade restrictions.** The Tax Court, in Whitehouse Hotel Limited Partnership, 131 TC No. 10, has taken great pains to show that, while some valuations for tax purposes are difficult to determine, it will not “settle on the difference,” but rather will demand that an often-complex methodology be used to substantiate certain charitable deductions. The court found in a case involving a façade easement that a disregard for detail in valuation not only produced an incorrect bottom-line tax liability but also showed a “lack of good faith” that allowed the IRS to impose Code Sec. 6662(a) accuracy-related penalties.

- **FLPs less valuable.** The Tax Court continues to discount marketability discounts claimed by taxpayers on gifts of limited partnership interests. In Holman Jr., 130 TC No. 12, the court reduced the discount from 35 percent to 12.5 percent. The court found no bona fide business purposes for the transfer restrictions in the partnership agreement, but nevertheless allowed 12.5 percent. Some planners are looking at the bright side, however, and are calling the glass half-full with FLPs still a viable strategy.

The most common basis of valuation of property for tax purposes is fair market value the price at which a property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

Situations in which valuation is required include, but are not limited to, estate and gift tax matters, casualty losses, exchanges of property, use of the insolvency exception to cancellation-of-indebtedness income, receipt of property as compensation or as dividends, and charitable contributions.

Certain rules have developed in the past to determine fair market value in depressed markets. These rules, however, have been viewed for the most part as anomalies, untested for widespread application. The increasing number of cases likely to arise on valuation in depresses markets, however, is likely to change or at least refine these rules.

Here is a list of some of the “rules” assumed in the past to be applicable to valuations but perhaps ripe for challenge:

- Prices obtained at distressed sales, sales in restricted markets or at public auctions are not the best indication of value and are not conclusive, particularly if there is evidence that the property would sell for more under different circumstances.
- Sales occurring under unusual market conditions are not good indicators of fair market value.
- Neither the absence of any prospective buyers, nor the fact that property is unique and there is no market price, renders a property valueless.
- Only in rare and extraordinary cases in property considered to have no fair market value. A difference exists between value and liquidity, and the absence of liquidity does not mean that property has no fair market value.
- Subsequent events do not bear on present fair market value. However, a significantly lower or higher price obtained in a post-valuation sale can be strong evidence that the taxpayer's valuation was inaccurate.

During these times of extreme market volatility, some have suggested an expansion of the open transaction doctrine. Under this doctrine, if the value of property received in a transaction cannot be determined, the transaction may be left open, with the income tax consequences to be determined later when the property can be valued.

The courts and the IRS, however, rarely conclude that open transaction treatment is proper because property has no ascertainable value. The Tax Court, for example, has applied the Cohan rule, which estimated or approximates value, to determine the value of patents, patent applications and stock rights, where the taxpayer could not prove their exact value.

Given the general policy need in the tax law for closure, expansion of the open transaction doctrine to accommodate current market swings remains unlikely, but no doubt will be argued more vigorously.

The burden of proving the value of property is on the taxpayer. If the IRS disputes the taxpayer's valuation and asserts a deficiency, the IRS's determination of value is presumed accurate. In any subsequent proceeding, the burden of proof is on the taxpayer to prove that the IRS erred. Both the taxpayer and the RIS can introduce appraisals and the testimony of expert witnesses.

Unfortunately, the IRS does not ordinarily rule in advance on the valuation of property. Under rare circumstances, it says that it will issue advance ruling if the taxpayer demonstrates unique and compelling reasons. Anecdotal evidence appears to confirm that the IRS is not accepting the difficulties in valuation during the present economy as sufficiently "unique and compelling" as to warrant its advance assistance.

Valuation has been called an art as well as a science. The "art" particularly comes to bear in weighing the impact of trends and economic forecasts on current market price. The result is that, in an economy in which expert opinions vary so widely on the future, setting the precise "fair market value" for certain assets essential to many tax strategies appears to have become at least in part a "guessing game," albeit one in which an educated guess is required.

How lenient the IRS and the courts will be on current valuations looking back at these times on audit or in litigation remains to be seen. However, the responsibility is left to tax advisors to come up with numbers now, rather than later, in an environment that challenges clear precedent.