Paragraph’s 8, 9, and 10 from NACVA

Letter of October 27, 2016

Re: Comments Regarding Proposed Treasury Regulation (REG. 163113-02) (to be used also as an Outline of Topics to be Discussed at the Public Hearing Scheduled for December 1, 2016.)

8. **<u>Under these Proposed Regulations, NACVA Members may be Limited in their Ability to Perform Qualified Appraisals</u>**

The proposed regulations conflict with Treasury's definition of a "qualified appraisal":

> IRC Section 170(f)(11)(E)(i), paraphrased, provides that the term "qualified appraisal" means an appraisal that is (1) treated as a qualified appraisal under regulations or other guidance prescribed by the Secretary, and (2) conducted by a qualified appraiser in accordance with generally accepted appraisal standards and regulations or other guidance prescribed by the Secretary. An appraisal will be treated as having been conducted in accordance with generally accepted appraisal standards within the meaning of Code Section 170(f)(11)(E)(i)(ii) if, for example, the appraisal is

consistent with the substance and principles of the “USPAP”, as developed by the Appraisal Standards Board of the Appraisal Foundation. (Note that the Appraisal Foundation created these standards at the request of the United States Congress.)

In the 2016-2017 Edition of The Appraisal Foundation’s Uniform Standards of Professional Appraisal Practice, Standards Rule 9-4(d) states:

> “An appraiser must, when necessary for credible assignment results, analyze the effect on value, if any, of the extent to which the interest appraised contains elements of ownership control and is marketable and/or liquid.”

In the comment section it further states:

> "An appraiser must analyze factors such as holding period, interim benefits, and the difficulty and cost of marketing the subject interest. Equity interests in a business enterprise are not necessarily worth the pro rata share of the business enterprise interest value as a whole. Also, the value of the business enterprise is not necessarily a direct mathematical extension of the value of the fractional interests. The degree of control, marketability and/or liquidity, or lack thereof, depends on a broad variety of facts and circumstances that must be analyzed when applicable."

All of the industry's major valuation organizations recognize the applicability of valuation discounts and have long done so. For instance, The Professional Standards of (NACVA) Section IV

Development Standard H, Fundamental Analysis, state: “For a conclusion of value, the member must obtain and analyze applicable information, as available, to accomplish the assignment, including, (8) Size of interest to be valued and its control, liquidity and marketability characteristics.”

Statements on Standards for Valuation Services Section 100.40, published by the American Institute of Certified Public Accountants, 2015 states: “During the course of a valuation engagement, the valuation analyst should consider whether valuation adjustments (discounts or premiums) should be made to a pre-adjusted value. Examples of valuation adjustments for a valuation of a business, business ownership interest, or security include a discount for lack of marketability or liquidity and a discount for lack of control.”

The proposed regulations fail to consider the economic reality of investor risk associated with holding a fractional equity ownership

interest in a privately held company that carries neither the attribute of control or marketability. As such, the proposed regulations fail to consider the economic reality of valuation discounts. These discounts, very often, take into consideration other issues apart from those enunciated in the proposed regulations, specifically for the lapse of voting rights and restrictions. A listing (not all inclusive) of those additional elements that warrant consideration of discounts include:

1. Appoint or change management,
2. Decide on compensation levels,
3. Enter into binding contracts,
4. Decide on the amounts of dividends or distributions,
5. Determine capital expenditures,
6. Change the capital structure,
7. Determine policy, including changing the directions of the business, and
8. Block any of the above actions.

A discount for lack of marketability or liquidity is commonly applied to reflect the lack of a recognized market to sell the interest, and the fact that some ownership interests are not readily transferable. Failure to consider or recognize valuation discounts will result in a value that is not determined in accordance with generally accepted appraisal standards, and ultimately be considered “hypothetical” as defined in the USPAP.

9. The Proposed Regulations Force Valuators to Perform Hypothetical Appraisals

Business valuators that issue business valuation reports under the proposed assumption that any holder can demand liquidation of his/her interest at any time at minimum value and receive cash or property pro rata to the interest, would be required to disclose the nature of such an assumption as a qualifying assumption and limiting condition. Further, in accordance with business valuation standards, the business valuator would be required to state that these valuations are "hypothetical" in nature, which is not consistent with the standard of value defined as fair market value. Thus, the proposed regulation requires the business valuator to arrive at a fair market value of interests under hypothetical assumptions that are known to be untrue, in conflict with governing legal documents and state law, and possibly, may even be commercially unviable.

According to the fair market determinations of value under the proposed regulations, "…if an interest in a corporation or a partnership (an entity), whether domestic or foreign, is transferred to or for the benefit of a member of the transferor's family, and the transferor and/or members of the transferor's family control the entity immediately before the transfer, any restriction described in paragraph (b) of this section[9] is disregarded, and the transferred interest is valued as provided in paragraph (f) of this section."[10]

Consequently, the business valuator in the process of valuing the equity ownership interest would refer to paragraph (f) of the proposed regulations in performing the valuation which provides the business valuator the following guidance:

---

[9] Proposed Regulation Section 25.2704-3(b) Disregarded restrictions means a restriction that is a limitation on the ability to redeem or liquidate an interest in an entity that is described in any one or more of paragraphs (b)(1)(i) through (iv) of this section, if the restriction, in whole or in part, either lapses after the transfer or can be removed by the transferor or any member of the transferor's family (subject to paragraph (b)(4) of this section), either alone or collectively.

[10] Proposed Regulation Section 25.2704-3(a).

> "If a restriction is disregarded under this section, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the disregarded restriction does not exist in the governing documents, local law, or otherwise."[11]

Again, as noted above, the foregoing guidance provides that the value of the transferred interest is to be determined under the fair market value standard and employing generally applicable valuation principles. However, the business valuator in his/her determination of fair market value is to assume that all disregarded restrictions do not exist in the governing documents or anywhere else, such as under state law. However, these disregarded restrictions are absolutely real and legally binding on the holders of such equity interests in the family entity, thus forcing the business valuator to

[11] Proposed Regulation Section 25.2704-3(f).

make “hypothetical” assumptions and render a hypothetical appraisal, which is *not* fair market value.

Note further that the proposed regulations do not make the same assertions with respect to equity ownership interests held by equity holders outside the familial equity owner group. It is difficult to understand in the proposed regulations how these provisions and restrictions can be considered in the valuation of one identical interest held by a non-family member, while disregarded by a family member. NACVA views this inconsistency as ill-conceived requiring the hypothetical findings noted above and lacking any relationship with market realities.

10. <u>It will be Impossible to Comply with USPAP and Any Other Industry Standards and Simultaneously Comply with the Proposed Regulations.</u>

According to USPAP, a "Hypothetical" appraisal or a "Hypothetical Condition" is defined as:

> A condition, directly related to a specific assignment, which is contrary to what is known by the appraiser to exist on the effective date of the assignment results, but is used for the purpose of analysis. Hypothetical conditions are contrary to known facts about the physical, legal, or economic characteristics of the subject property; or about conditions external to the property, such as market conditions or trends, or about the integrity of data used in an analysis.[12]

[12] USPAP 2016-2017 Edition, Page 3.

In addition, USPAP defines an “Extraordinary Assumption” as:

> An assumption directly related to a specific assignment, as of the effective date of the assignment results, which, if found to be false, could alter the appraiser’s opinions or conclusions. Extraordinary assumptions presume as fact otherwise uncertain information about physical, legal, or economic characteristics of the subject property; or about conditions external to the property, such as market conditions or trends; or about the integrity of data used in an analysis.[13]

The difference between whether a condition is hypothetical or extraordinary rests on what the appraiser knows about the condition in question. If an appraiser cannot verify a certain condition that is

---

[13] *Ibid.*

critical to the valuation, but which the appraiser has a reasonable basis to accept as true, then the condition is an extraordinary assumption. Alternatively, if the appraiser is asked to use a condition he/she knows to be false, but which is necessary for the analysis, a hypothetical condition applies.[14]

It appears that the assumption delineated in the proposed regulations about disregarded restrictions would not be an extraordinary assumption, but rather, a hypothetical condition because such conditions under the proposed regulations are known to be false and contrary to fact as evidenced by the governing documents and state law. Further, according to USPAP, any such appraisal report would require that the value be clearly labeled as hypothetical, the purpose of such appraisal is stated, and the conditions assumed are set forth in the report.

[14] USPAP 2016-2107 Edition, Page 307.

Similarly, the AICPA Statement of Standards for Valuation Services ("SSVS") has incorporated in Appendix C—Glossary of Additional Terms, a "hypothetical condition," as: "that which is or may be contrary to what exists, but is *supposed* [emphasis added] for the purpose of analysis".[15] Further, the business valuation report is required to disclose any hypothetical conditions used in the valuation engagement including the basis for their use.[16]

Finally, NACVA's professional standards also require that "hypothetical conditions" be disclosed in the business valuation report, with reasons for their inclusion. NACVA does not define hypothetical conditions.[17]

---

[15] "Appendix C – Glossary of Additional Terms," SSVS VS Section 100 (AICPA).
[16] SSVS VS Section 100.22.
[17] NACVA Professional Standards, V – Reporting Standards, Paragraph C.

Based upon the foregoing comments observations and discussions, it would seem reasonable that business valuations rendered for gift and estate tax purposes under the proposed regulations would require that such opinions or estimates of value be labeled as hypothetical determinations, not fair market value.