

# Business Valuation Notes

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## Pension Protection Act ...

# APPRAISERS' RISK IS UP

## IRS Code ...

Clients' due diligence when hiring an appraiser has become more important as a result of recently issued government directives, and changes have also increased potentially liability to the appraiser.

A new public law relating to pensions and changes in Internal Revenue Service definitions have refined the definition of a qualified appraiser and a qualified appraisal. The IRS issued Internal Revenue Bulletin 2006-46 November 13, 2006, setting forth transitional guidelines, awaiting more clarification.

MBVG President Randall Schostag said he sees the new requirements as a clarification of expectations for both the client and the appraiser. "Unfortunately, there have been too many instances where an appraiser has become a 'hired gun', developing a value that the client wants rather than what is realistic. The



Schostag

required changes ensure that the work will be done by an analyst who is qualified, and also provides hefty penalties to appraisers whose opinion can be bought." In September 2006 the Pension Protection Act of 2006 was signed into law. Section 1219 of the law changes appraisal requirements for tax purposes in two areas: Under Section

170 of the Internal Revenue Code the definitions of Qualified Appraisal and Qualified Appraiser are changed. The definition of Qualified Appraisal now refers to "generally accepted appraisal standards." And the definition of a Qualified Appraiser now includes the term "earned an appraisal designation from recognized professional organization."

"The legal precedent was established under Kumo Tire and Daubert requiring appraisers to use methods which have been accepted by the appraisal community," Schostag said. "If the methods used have not been reviewed and accepted by others in the appraisal community, there has been a chance that an appraisal opinion may be thrown out of court. At the Minnesota Business Valuation Group we consider the new measures passed to codify what common law has already set."

The Internal Revenue Code referenced is Code Section 6695A applies to anyone preparing an appraisal who knows or reasonably should have known that the appraisal would be used in connection with a tax return or claim for refund. In this regard, an attorney, tax-preparer-CPA, or even an executor could be deemed an appraiser.

Any appraiser who submits an appraisal with a "substantial" or "gross" misstatement of value may be subject to a penalty payable by the appraiser based on

(Continued on page 3 ... Qualified)

## CONSERVATION EASEMENT DONATION TAX REDUCTION

### Be Careful...

Valuing conservation easements has acquired a new status with the passage deductions for donations. The Minnesota Business Valuation Group has added expertise to assist taxpayers with those donations.

In August 2006, President Bush signed into law expansions of the federal conservation tax incentive for conservation easement donations. For donations made in 2006 and 2007, the deduction a landowner can take for

donating a conservation easement has been raised from 30% to 50% in any one year. The new law also allows qualifying farmers and ranchers to deduct up to 100% of their income and the law extends the carry-forward period for a donor to take tax deductions for a voluntary conservation easement from 5 to 15 years.

MBVG Principal Ron Bruzek said that the changes are expected to give incentives to more land holders to take advantage of this little-known tool for protecting the environment and doing tax and estate planning.

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# CONSERVATION EASEMENTS

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Bruzek is a certified MBVG appraiser for both real estate and equipment.

Bruzek said, a charitable contribution deduction for the gift of a conservation easement has been allowed by the IRS in revenue rulings since 1964. Land trusts have been in existence since 1950's, he added.

In over a half decade, according to the Land Trust Alliance (founded in 1982 by national land trusts to share knowledge, expertise and resources) there are over 1,500 local and regional land trusts. Land trusts and property acreage protected have been growing exponentially over this period, led predominantly by the east and west coast states. Overall, land trusts have been reported to have saved more than 34 million acres — an area far larger than the entire National Park System in the lower 48 states.

Along with rapid growth typically come abuses, Bruzek noted. In 2003 the *Washington Post* published articles related to financial irregularities and conflict of interest used by conservation groups. The well publicized articles lead to Senate Finance Committee investigations and IRS audits.

“These activities are not typical for charities,” Bruzek said. “We expecting that more regulations and scrutiny will be the likely government response.”

The industry response has been predominately in the form of land trust accreditation programs. With the fore-going issues in play and other issues, such as long term stewardship of conservation easements, accreditation should provide uniform independent verification of established land trust standards and practices that indicate a land trust's ability to operate in an ethical, legal, and technically sound manner to ensure the long-term protection of land in the public interest.

The appraisal industry is now at work to establish uniform guidelines, education, and certifications for conser-

vation easement valuations, Bruzek said.

Organizations accepting donations of conservation easements are part of a system of nonprofit entities and government agencies that are finding conservation easements an increasingly important tool for protecting the diminishing natural and historic resources for present and future generations. Negligence by any one organization may threaten the easement program of all, according to Bruzek. Opposition to easements in Congress or at the IRS could lead to elimination or seriously restricting the tax deductions that are such a critical incentive for property owners.

Conservation easements are basically a middle point in real property rights flanked by full fee simple ownership and government land use regulation. “For example, consider the real property theory of the “bundle of rights”, where fee simple ownership is the bundle of sticks representing all the separate and distinct property rights, such as the right to use, to occupy, to sell, to lease, to give it away, air rights, mineral rights, or development rights.” Bruzek said. “A conservation easement limits the future use of a property or removes one or more of these sticks. Therefore, only a partial interest remains in a property subject to a conservation easement.”

Conservation easements are recorded land use agreements in which the property owner conveys to a governmental unit or charitable organization certain rights to be enforced by the holder for public benefit. It can assure that the historic, scenic, natural or open space attributes that make the property significant are fully identified and protected against intentional or unintentional damage.

In the early 1980's the Uniform Conservation Easement Act defined a conservation easement as “...a nonpossessory interest of a holder in real property imposing limitations or affirmative obligations the purpose of which include retaining or protecting natural, scenic, or open-space values of real property, assuring its availability for agricultural, forest,

recreational, or open-space use, protecting natural resources, maintaining or enhancing air or water quality, or preserving the historical, architectural, archaeological, or cultural aspects of real property”.

A property owner can sell a conservation easement, but typically the easements are donated, Bruzek said. If the donation benefits the public, is created in perpetuity, and satisfies other federal tax code requirements, it can qualify as a tax-deductible charitable donation.

Two valuation methods can be employed to estimate the value of the easement/donation, according to Bruzek. The first method, tried and true, court tested and IRS approved is the “before and after” analysis. This analysis, similar in eminent domain appraisals, appraises the property value “as is” before the affects of the conservation easement. The after valuation takes into consideration the ramifications of the easement. The difference between the two analyses is the value of the conservation easement rights or interest.

The second valuation approach, becoming more popular as the use of conservation easements increases, is the selling price value, in arms-length transactions, of other properties encumbered with comparable easements. This approach involves direct comparisons of similar properties that have sold in the same or similar markets with the property being appraised to derive a market value indication.

## CAUX ROUND TABLE & MBVG

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# QUALIFIED

(Continued from page 1)

the lower of two factors: 1. \$1,000 or 10% of the tax underpayment (whichever is greater), or (2) 125% of the appraisal fee. Thus, most of the time the appraiser will be exposed to a fine (a nondeductible penalty) of 125% of their fee.

A substantial misstatement of value is defined as 150% of the amount ultimately determined to be the correct value (for overvaluation), or 40% of the amount ultimately determined to be the correct value (for undervaluation). These provisions apply to both income tax and transfer tax issues, including: charitable gifts, income tax deductions, estate taxes, gift taxes, and the like. The new penalty does not appear to apply to appraisals for the purpose of existing tax litigation support, such as expert witnesses engaged after the tax return was filed.

“Adoption of these definitions and penalties increases the risk to appraisers and their potential liability,” Schostag said. “There is a possibility of an appraiser induced penalty even if we did not know or realize at the time of the appraisal that the work could result in an underpayment of tax. Up to now Section 6701 of the code allowed the IRS to impose a penalty only if the appraiser knew it would result in an underpayment – in other words colluded with the taxpayer. Previously the IRS had the burden of proof; now the burden of proof has shifted to the appraiser and taxpayer. The only way to avoid the penalty is by appeal to the Treasury Department, which is the same regulator which may impose the penalty.”

Appraisers are now subject to the same criteria as lawyers and accountants for IRS practice as set forth in Circular 230, Schostag said. He added, it seems likely with these new rules that appraisers can be blacklisted from ever again being able to present expert testimony before the Treasury or IRS proceedings.

According to notice 2006-96; 2006-46 IRB 1, tax returns filed after February 16, 2007, must include a statement that the appraiser understands that an appraising resulting in substantial or gross valuation misstatement may be subject to the penalty.

## FASB REDEFINES FAIR VALUE

The Financial Accounting Standards Board has redefined “Fair Value”, established a framework for measuring fair value, and expanded disclosure requirements regarding fair value. On September 15, 2006, FASB issued FAS 157. Adoption will be required for fiscal years beginning after November 15, 2007 and for interim periods within those years.

MBVG has commented in past issues of *Business Valuation Notes* that the definition of fair value has been inconsistent, which has made some valuation analyses and reporting for accounting purposes difficult. It notes that FAS 157 will still not be required for share-based payment transactions such as SFAS 123.

In other recent statements of accounting standards the board has stressed the use of the market approach. FAS 157 puts forth greater emphasis on fair value as a market-based measurement as opposed to an entity-specific measurement. According to the new standard, fair value is “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” In other words, it is an exit price rather than an entry price.

The definition is based on the assumptions that market participants would use for pricing in the principal or most advantageous market and that both parties are independent, knowledgeable, and willing to enter into the transaction.

FAS 157 sets forth a value hierarchy which prioritizes the methods appraisers use, giving preference to quoted prices in active markets and giving the lowest priority to unobservable inputs such as a reporting unit’s own data. The following are the

preference levels, with level 1 most preferred:

Quoted prices in active markets

Observable inputs:

Quoted prices for similar assets or liabilities in active markets

Quoted prices for identical assets / liabilities in inactive markets

Observable inputs other than quoted prices, such as interest rates and yield curves

Inputs derived from or corroborated by observable market data by correlation or other means

Unobservable inputs which are the best obtainable under certain circumstances, such as unit’s own data.

The new standard introduces new disclosure requirements relating to these fair value measurements. These include disclosing the level within the fair value hierarchy in which the measurements fall, for non-recurring assets / liabilities, a description of inputs and information used when using level 3 inputs, reconciliation of beginning and ending balances, total gains and losses, and transfers if using significant level 3 inputs, and a discussion of any changes in valuation techniques when changes are made year-to-year.

## The MBVG Team

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#### **BUSINESS VALUATION**

Goodwill Impairment Analysis (141/142)

Businesses

Intellectual Property

Intangible Assets

Options

Strategic Planning

ESOP

Divorce

Shareholder Oppression / Dissenting Rights

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Merger / Acquisitions

Fairness Opinions /Purchase Allocation

Planning

#### **BUSINESS ASSET VALUATION**

Experts or Consultants

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