Business Valuations: One-of-a-Kind Assets Require a Unique Valuation Approach

Problems can arise when valuing estates that hold assets produced by the personal or artistic efforts of a decedent. The assets of two deceased celebrities, singer Michael Jackson and writer J.D. Salinger, illustrate this point.

Both celebrities reportedly owned assets that were likely to generate income after their deaths. Jackson's estate includes a portfolio of songs and his share of a music catalog that includes rights to many Beatles songs. Salinger's estate includes five completed manuscripts that were scheduled to be published years after his death.

These one-of-a-kind assets can be difficult to value as of the date of death, however. The fair market value of Jackson's songs has certainly increased since his death. And, even though Salinger's manuscripts were not widely known at the time of his death, their fair market values also likely increased after his death — especially since Salinger hadn't published any new works since 1965.

Estates and the IRS at Odds

These situations draw a battle line between estates and the IRS, because the date of death is generally the date of valuation for federal estate tax purposes. (For example, the IRS and the estate of Michael Jackson disagreed over the value of Jackson's public image at the time of his death.) The difficulty in determining fair market value at the date of death has caused more than one appraiser to declare that valuation is more an art than a science.

Unique assets aren't just held by the rich and famous, however. Private business interests, patents, copyrights, websites, domain names, and art collections are common assets held by ordinary people who die with taxable estates. The IRS, of course, is interested in collecting the taxes due on the value of these assets at the decedent's death.

Exactly how much an asset will increase (or decrease) in value when its owner dies is highly speculative. Hindsight is 20/20. But when valuing assets for estate tax purposes, appraisers generally must use only information that was "known or knowable" on the date of death — or the alternate valuation date, which is six months later

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Put It in Writing

In any valuation assignment, a written report helps support an appraiser's opinion. This format is especially important for estate tax purposes, because it typically serves as a valuation expert's direct testimony in Tax Court.

A written report must have these two elements in order to the support the expert's conclusion:

1. Fair market value must be based on a reasonable theory and established valuation methodology. Without this key element, no report will sustain a value — and the expert may be disqualified from testifying, if challenged by the IRS.

2. The report must be understandable, readable and detailed. If not, the IRS or judge will be confused and possibly misunderstand the analyses underlying the expert's conclusion.

To begin the three-year statute of limitations on gifts, IRS adequate-disclosure regulations dictate that taxpayers attach a "qualified appraisal" to their returns. Alternatively, they can provide their own detailed descriptions of the methods used to value gifts.

If these disclosures are not provided with a gift tax return, the IRS can challenge the value of gifts years later, including on the date of death.

Valuation Challenges

Intangible assets can be especially difficult to value. For example, an interest in a one-partner law firm can suddenly have little or no value upon the death of its owner. That's because most of the law firm's fair market value comes from personal goodwill that was inextricably linked to the owner as an individual, rather than the business as an operating entity. If the attorney hadn't died, the law firm might have been sold to another practitioner by gradually transitioning personal relationships and knowledge to the new owner.

Other assets might have a value at death that is not fully developed. For example, a patent might require more research and development to make it usable or able to be sold. In that case, the patent's fair market value to the estate is probably lower than its eventual selling price. Here, the future value is speculative at the date of death and only the present value determinable at death — including additional expenditures and contingencies — is included in the estate.

No universal model or formula provides the answer as to the fair market value of unique assets on the date of death. Instead, the appraiser must analyze the unique characteristics of the asset and develop a road map for determining its value.

Expert Credentials

Death is an event that can alter the fair market value of a unique asset. How much an asset's value increases (or decreases) when its owner dies varies from asset to asset. Valuation experts are hired by both estates and the IRS to determine fair market value on the date of death (or the alternate valuation date).

A "qualified appraisal" (see box on page one) isn't required to substantiate asset values for estate tax purposes. But if a formal written appraisal prepared by an unbiased valuation professional is attached to your estate tax return, it provides a strong foundation for the fair market value of hard-to-value assets — making it less likely that the IRS will challenge your return.

Before hiring someone to value one-of-a-kind assets, evaluate whether he or she has completed all coursework, experience and continuing professional education requirements to be called a "qualified appraiser" from a reputable appraisal organization.

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