

Fair Market Value: Appraisal Practice in an Evolving Legal Framework

The Increased Complexity of Business Arrangements Creates the Need for More Compliance-Driven Appraisal Opinions

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The term "fair market value" has become increasingly important in financial transactions involving companies in the health care services industry, especially those claiming Sections 501(c)(3) or (c)(4) status.¹ With the economic pressures of rising operating costs and reduced third-party reimbursement, health care providers are exploring ways to share resources, reduce fixed costs, and generate revenue from new sources. Today's economic climate has forced the creation of a variety of joint venture affiliations, management service agreements, and licensing arrangements that have largely replaced the traditional acquisition model (M&A) for development. Whether a financial transaction is a purchase, sale, or other contractual arrangement, fair market value (FMV) has become a major area of concern for many health care providers because a lack of support for a financial arrangement can result in very significant consequences to all parties, including the appraiser.

WHY AND WHEN DO WE NEED A FAIR MARKET VALUE STANDARD?

In the health care services industry, the relationship between physicians and medical facilities is one of co-dependence. Physicians are a vital component of a medical facility's financial viability: only a physician can order the provision of services before a medical facility can begin to bill Medicare or other third-party health insurance providers; however, not all physician relationships with medical facilities are equally dependent. For example, family practice or pediatric physicians treat the ma-

jority of their patients in an office environment, whereas a surgeon may rely almost exclusively on an inpatient facility to practice medicine. For most physicians, however, reliance on a medical facility lies somewhere in between these two extremes.

Mutual dependency often provides the incentive for physicians and medical facilities to enter into transactions such as the purchase of a physician's practice or the lease of office space located on or near a medical campus. Both for-profit and not-for-profit health care providers accepting payments from government programs such as Medicare or Medicaid must ensure that business transactions entered into with other providers are at FMV.²

According to the Office of Inspector General (OIG) of the Department of Health and Human Services (HHS), the purpose of the FMV standard in the health care industry is "to protect patients and the federal health care programs from fraud and abuse by curtailing the corrupting influence of money on health care decisions." In situations involving potential monetary incentives between physicians and medical facilities, regulatory standards such as those embodied in the federal program anti-kickback statute, the Medicare Ethics in Patient Referrals law (Stark law), and the Internal Revenue Service's (IRS's) intermediate sanctions regulations and inurement proscription impose certain constraints on appraisers to analyze FMV.³ If the approach and methodology an appraiser uses to estimate FMV are too far removed from the legal guidance defining the valuation framework, the providers could be exposed to significant sanctions, including exclusion from federal reimbursement programs, fines, penalties, and, in theory, even imprisonment in the case of criminal violations.⁴

TRUTH OR CONSEQUENCES

The federal anti-kickback law has been in existence since 1972.⁵ The law states that anyone who knowingly and willfully receives, pays, offers, or solicits anything of

value to influence the referral of federal health care program business, including Medicare and Medicaid, can be guilty of a felony. The federal anti-kickback statute makes it illegal, for example, for a hospital to pay a physician for the flow of patient referrals to that hospital in the future when his or her practice is acquired.⁶

As such, a gross overvaluation of a medical practice is assumed by regulatory authorities to be a payment for the physician's referral pattern and thus may be subject to penalties under this statute. For this reason, appraisals of physician organizations do not consider the indirect value of potential future referrals, if any, to a buyer when arriving at FMV. Indirectly, the federal anti-kickback statute also restricts the recognition of any intangible asset value related to patient relationships or future referral activity under Statement of Financial Accounting Standards 141 (SFAS 141(R)), despite possessing the characteristics of an intangible asset.⁷

The Stark law is comprised of a number of provisions that govern physician self-referral for certain Medicare covered services.⁸ The law is intended to safeguard the nature of patient relationships by prohibiting physicians from referring Medicare patients to clinical laboratories or other entities such as hospitals, providing "designated health services" under the law, in which the physicians hold a financial interest. The Stark law applies to both a physician's financial relationships with his own medical practice to which he may make "referrals" and to a physician's direct or indirect financial relationships with outside entities, such as hospitals, to which the physician refers.

From an appraisal perspective, the Stark law is intended to exclude the value of referrals or other business generated for a medical facility when evaluating a physician's aggregate consideration from a transaction or financial arrangement. In many ways, the Stark law is similar to the federal anti-kickback statute but differs in its legal consequences and enforcement options.⁹

In addition to the anti-kickback statute and the Stark law, certain tax-exempt organizations can have other problems if the boundaries of FMV are exceeded. The IRS has the authority to regulate the activities of tax-exempt organizations, including those described in Sections 501(c)(3) and (c)(4). As a requirement of tax-exempt status under Section 501(c)(3), the operations of a charitable enterprise must not be organized or operated for the benefit of private interests.¹⁰ In the context of valuation, if a tax-exempt organization provides remuneration in a business transaction at more than FMV, impermissible (*i.e.*, more than incidental), private benefit, and possibly inurement,¹¹ may result. Either finding could cause a loss of exempt status and/or penalty excise taxes under Section §4958 (“intermediate sanctions”).¹²

Intermediate sanctions are a series of potential taxes and penalties directed toward disqualified persons, *i.e.*, “insiders,”¹³ who are found to have engaged in an “excess benefit” transaction with an exempt organization.¹⁴ An “excess benefit” transaction involves an insider who receives more from a transaction with a charitable organization than he or she gives in return. It is important for appraisers to recognize that “excess benefits” may occur in many forms under the IRS’ theory of intermediate sanctions, including excessive compensation,¹⁵ payment of excessive rent,¹⁶ receipt of less than FMV in sales or exchanges of property,¹⁷ or through tax-status conversion transactions,¹⁸ among others.

FMV: THEORY AND PRACTICE

Standard of Value

There are a number of different standards of value. The standard of value applied to a particular appraisal will be determined either by the requirements of law, such as in divorce or estate proceedings, or by preference of the client for a specific purpose. Some standards of value are FMV, fair value, investment value, and liquidation val-

ue, among others. The standard of value addresses the question of “value to whom?”

With the exception of the “fair value” standard used in financial reporting, most appraisals are performed using the definition of FMV outlined in Revenue Ruling 59-60.¹⁹ It is the standard that applies to all federal and state tax matters; it is also the legal standard of value in many other valuation situations; however, most transactions in the health care services industry include either a health care provider or medical facility billing Medicaid or Medicare for designated health services (DHS).

The Stark law generally prohibits a physician from referring Medicare patients to a medical facility for the furnishing of DHS if the physician or immediate family members have a financial interest in the entity, unless an exception applies.²⁰ For providers and medical facilities to meet the requirement of FMV, found in most of the direct exceptions to the Stark law’s prohibitions, financial arrangements between physicians and medical facilities are required to be measured relative to market values²¹ and be commercially reasonable.²²

The definition of FMV most often considered in a regulatory review of a financial transaction is contained in the Stark law. The Stark law modifies the IRS’ definition of FMV for commercial purposes because of the co-dependent relationship between physician and medical facility. To qualify as satisfying the FMV requirement, the Stark law requires that remuneration between a physician and medical facility not be determined in a way that takes into account the volume or value of referrals or, generally, other business generated between the parties to a transaction.²³ The Stark law defines FMV as the value in an arm’s length transaction, consistent with the general market value.²⁴

The “general market value” is defined as

...the price that an asset would bring as the result of bona fide bargaining between well-informed buyers and

sellers who are not otherwise in a position to generate business for the other party, or the compensation that would be included in a service agreement as the result of bona fide bargaining between well informed parties to the agreement who are not in a position to generate business for the other party on the date of acquisition of the asset or at the time of the service agreement.²⁵

Buyers and sellers under the standard of general market value are assumed to possess certain attributes during a negotiation process: (a) independence (they are not related parties); (b) knowledge of all available information, including that which would be obtained through due diligence efforts that are usual and customary; (c) the ability to engage in a transaction, both legally and financially; and (d) willingness to transact; that is, they are motivated but not forced to do so.²⁶

Under the general market value standard, willing buyers and willing sellers are hypothetical persons rather than specific individuals or entities, and the characteristics of these hypothetical persons are not necessarily identical to the personal characteristics of the actual seller or buyer.²⁷ “General market value” is based on reasonable assumptions as to the actions of “any willing buyer;” it is intended to measure a subject business interest or financial arrangement on an “as is where as” basis.²⁸

Under alternative theories of market value, such as “fair value” developed in the accounting literature, the behavior assumptions of a market participant are measured from a much different perspective. Under Financial Accounting Standards Board’s *Statement of Financial Accounting Statement No. 157*²⁹ (“SFAS 157”), a transaction is considered from the perspective of a “market participant” that holds the subject asset rather than estimating the value of a subject business interest on an “as is where as” basis. The measurement assumptions of fair value contained in

SFAS 157 focus on the seller’s expected value to sell the subject asset (“exit price”),³⁰ not on the price that would be paid by any willing buyer to acquire the asset (“entry price”).

Essentially, exit price and entry price are similar theories of market participant behavior viewed from opposite vantage points in a hypothetical transaction. For example, the assumptions underlying entry price prohibit an appraiser from ascribing value to a subject medical practice for financial improvements that can only be achieved through the economies of scale of a tax-exempt buyer. Similarly, any assumptions of future profit margin improvement in the valuation of an acquired medical business should not presume use of assets controlled by a tax-exempt organization. These potential valuation adjustments are more reflective of the seller’s value paradigm or an exit price rather than applicable to an analysis under the definition of general market value.³¹

Despite these theoretical differences between fair market value and fair value, one of the most important concepts in establishing the value under either set of assumptions has always been the relationship between risk and reward. A specific transaction structure is unlikely to be at FMV if the return to the investors is not commensurate with the business risk taken.

PREMISE OF VALUE: THE PARADIGM OF FAIR MARKET VALUE

The choice of the premise of value is critical to the purpose of the appraisal. While FMV addresses the question “value to whom,” the premise of value answers the general question “in what type of market circumstances.”

Estimating FMV depends upon the situation in which the business is valued. Consider, for example, a business that is for sale and will continue operating under the new ownership as compared to a business that will be shut down and its assets sold at auction. Clearly, the value of the business under different circumstances will be quite different. There are four commonly used premises of value.

1. Value in Continued Use, as a Going Concern

Under this premise, it is assumed the assets of a business enterprise are income producing and will be sold as a mass assemblage. This premise of value captures the benefits from mutually synergistic relationships of the business' tangible assets to the intangible assets and of the intangible assets to the tangible assets.³²

2. Value in Place, as an Assemblage of Assets

Under this premise, the assets of a business are sold as a mass assemblage, are capable of producing income, but are not currently attached to a going concern enterprise. While there is still synergistic value between a business' intangible assets and its tangible assets (and vice versa), this premise would exclude the economic benefits to the business of specific intangible assets such as the investment in a workforce, going concern value, and goodwill.³³

3. Value in Exchange, as an Orderly Disposition

Under this premise the assets of a business are sold piecemeal and not as part of a mass assemblage of assets. This premise assumes the business will no longer be a

going concern and, thus, specifically excludes any contributory value provided by intangible assets and synergistic value between a business' intangible assets and its tangible assets (and vice versa).

4. Value in Exchange, as a Forced Liquidation

Under this premise the assets of a business are sold piecemeal and not as part of a mass assemblage of assets. The difference between this premise and that of an *orderly disposition* is the assumption of adequate exposure for the subject assets on the secondary market. The circumstances under this premise provide the business assets with limited market exposure to highest bidders, which may not represent the entire population of likely buyers.

Note that the same definition or standard of value (FMV) can apply to very different valuation situations, and therefore, different premises of value are necessary. The optimal premise for estimating FMV depends on the purpose of the appraisal. For example, a physician interested in the value of a medical practice for purposes of buying and continuing the practice would be assessing the business on the premise of a *going concern*. Alternately, a bank lender assessing the same medical practice to

Figure 1

Tax-Exempt Hospital Oncology Service Line Management Services Agreement Comparative Financial Impact Analysis ^(a) As of the Valuation Date (\$000s)												
	RTS	CoH	OCC	FCCC	DFCI	RCC	MSKCC	WMCC	KCI	Tax-Exempt Oncology Service Line	Negotiated MSA ¹¹	Tax-Exempt Oncology Service Line Pro-forma
Net Revenues	\$217,590.0	\$331,271.9	\$24,105.6	\$58,423.4	\$514,208.0	\$44,625.0	\$376,227.0	\$36,068.2	\$41,072.8	\$156,500.0		\$156,500.0
Cost and Expenses	138,518.0	237,347.2	15,792.4	43,478.8	351,246.0	32,738.5	241,222.0	26,136.6	28,709.8	88,100.0	9,202.0	97,302.0
Contribution to Overhead	79,072.0	93,924.7	8,313.2	14,944.6	162,962.0	11,886.5	135,005.0	9,931.6	12,363.0	68,400.0		59,198.0
Contribution Margin	36.3%	28.4%	34.5%	25.6%	31.7%	26.6%	35.9%	27.5%	30.1%	43.7%		37.8%

test the adequacy of loan collateral typically would base the value on a premise of *liquidation*. Selecting the “wrong” standard and premise of value often results in a value conclusion that is misleading and may cause serious problems.³⁴ Appraisals prepared for compliance use by a tax-exempt organization often couple FMV with the *going concern* premise of value.³⁵

COMMERCIAL REASONABLENESS

An inquiry into “commercial reasonableness” is an analysis of the underlying economics of the transaction without taking into account the potential for referrals between the parties. Commercial reasonableness is intended to safeguard the economics of a transaction involving a tax-exempt organization. As a whole, the analysis of commercial reasonableness is a separate and distinct process from determining whether a business transaction is established at FMV.

In the context of a business enterprise arrangement between physician and medical facility, HHS has interpreted “commercially reasonable” to be “a sensible, prudent business arrangement from the perspective of the particular parties involved, even in the absence of any potential referrals.”³⁶ Similarly, commentary to the Stark law’s regulations also suggests that “an arrangement will be considered ‘commercially reasonable’ in the absence of referrals if the arrangement would make commercial sense if entered into by a reasonable entity of similar type and size and a reasonable physician of similar scope and specialty, even if there were no potential DHS referrals.”³⁷

Absent from this guidance is a financial framework to quantitatively test the commercial reasonableness of a business transaction, leaving the parties and the appraiser exposed to potential regulatory actions. That is, even if an arrangement meets traditional FMV standards, if it does not meet commercial reasonableness standards, it may not withstand analysis under Stark. From an appraisal perspective, there must

be value created for both parties to the business transaction; otherwise, it would not be viewed as a commercially reasonable arrangement.

One possible test of commercial reasonableness is a benchmarking analysis that compares post-transaction or *pro forma* operating margins to industry standards. From a valuation perspective, this is a form of the market approach. Commercial reasonableness is assessed by comparing *pro forma* operating metrics of the tax-exempt organization to those of guideline entities. If the operating and financial performance of the tax-exempt entity differs substantially from the guideline businesses after consideration of a business combination, then the aggregate value under the negotiated terms is likely to be viewed as suspect. Otherwise, there exists evidence that the financial terms can be viewed, in aggregate, as within the likely range of FMV. Financial and operating metrics on guideline businesses required for this type of analysis can be found in the required filings of publicly traded companies with the U.S. Securities and Exchange Commission (SEC) and the IRS’ Form 990 for tax-exempt organizations.³⁸

Figure 1 provides the financial metrics of nine cancer treatment businesses and an oncology service line from a tax-exempt health care system. A benchmarking analysis indicates that the aggregate compensation under a proposed management services agreement (MSA) between the tax-exempt organization and local physician group has no impact on the rank order of the oncology service line’s contribution margin as compared to the nine guideline cancer treatment businesses. The aggregate compensation under the MSA does not put the tax-exempt entity’s service line at a financial disadvantage relative to comparable medical service businesses. As such, these results provide a piece of evidence indicating the financial terms of this MSA can be viewed as within the likely range of FMV and commercially reasonable.

While benchmarking helps an appraiser assess certain aspects of the commercial reasonableness requirement on relative profit margins, it does not provide an objective measurement of return on investment, one that evaluates the underlying economics of the business combination or compensation arrangement to *both parties*. Within the context of financial theory, this type of analysis is often referred to as capital budgeting.³⁹

Capital budgeting is the planning process used to determine whether a firm's long-term investments in items such as new medical equipment, business combinations, or physical plant are worth pursuing. Capital investment analysis determines which potential long-term projects are likely to provide sufficient economic returns to stakeholders. By comparing the resulting internal rate of return (IRR) on a capital investment to a tax-exempt organization's weighted average cost of capital (WACC), investments in projects can be compared easily to other investment vehicles and to investment hurdle rates such as a tax-exempt entity's WACC.

The resulting IRR from a capital investment that is greater than an entity's cost of capital creates value for a going-concern enterprise; on the other hand, if the IRR on a potential business combination or financial arrangement is below an entity's WACC, the result would be a suboptimal capital expenditure and one that possibly destroys commercial value. The consequences of the latter type of arrangement involving a tax-exempt organization could be viewed as a private benefit, and possibly inurement to certain individuals, potentially subjecting the tax-exempt entity to "intermediate sanctions" or revocation of its tax-exempt status in the extreme.

For business combinations or financial arrangements to be considered commercially reasonable, there must be quantifiable value created for the tax-exempt organization. In measuring this value, it is unclear whether the definition of commercial

reasonableness should incorporate only direct investment cash flows or if "halo"⁴⁰ cash flows also may be considered by the appraiser. Beyond addressing the typical considerations of commercial reasonableness in the valuation opinion, supplementing the report narrative with generally accepted financial analyses typically can rebut any regulatory concerns over the "reasonableness" of a transaction.

REASONABLE COMPENSATION

Another concept attached to the standard of FMV is that of "reasonableness" when assessing a physician compensation arrangement.⁴¹ The IRS generally defines "reasonable compensation" as the amount that ordinarily would be paid for like services by like entities in similar circumstances.⁴² The total value of compensation includes not only cash compensation but extras like sign-on bonuses, loan forgiveness, and other employer contributions to benefit expenses. Compensation is said to be "reasonable" when the total compensation package⁴³ is found to be reasonable relative to the services provided to the exempt organization.

The so-called "Phase II" regulations under Stark II created a degree of guidance and protection within the definition of FMV for hourly payments to physicians for their personal services that met certain benchmarks. The valuation methodologies prescribed within the FMV safe harbor were inflexible and typically could not accommodate compensation arrangements that were evolving rapidly in complexity.

The "Phase III" regulations eliminated this safe harbor and clarified that the FMV of administrative and clinical services may be different. Thus, under Phase III, an hourly rate "may be used to compensate physicians for both administrative and clinical work, provided that the rate paid for clinical work is FMV for clinical work performed and the rate paid for administrative work is FMV for the administrative work performed."⁴⁴

From an appraisal perspective, there is no guidance provided by regulatory authorities on how to establish the FMV of a compensation arrangement. Again, there are several definitions in the literature but no specific guidance on the elements needed to support an aggregate compensation level. In the past, certain regulatory authorities indicated that appraisers may rely on any commercially reasonable method that provides evidence of what is ordinarily paid in the relevant geographic area in an arm's length transaction among parties who are not in a position to refer to each other.⁴⁵ The new requirements for analyzing reasonable compensation under Phase III of the Stark regulations suggest these arrangements will be under increasing scrutiny.

Without a developed body of judicial or administrative rulings on the subject and the increasing regulatory scrutiny of physician compensation arrangements, deviations from conventional analysis could provide a "red flag." A well-reasoned approach that considers historical compensation levels, multiple national, regional, and/or local compensation surveys,⁴⁶ relative value unit (RVU) production, and the terms of the employment agreement will minimize many risks posed by an FMV compliance review.

In the ideal situation, cash compensation and work RVUs should be in similar relative percentiles of each respective distribution. If cash compensation or payment per work RVU to the physician is two standard deviations or more⁴⁷ from its expected value, the financial arrangement is likely to raise regulatory questions, including the data relied upon by the appraiser to support the terms of the agreement.

LEGAL DECISIONS SHAPING FAIR MARKET VALUE

The concept of FMV under the federal anti-kickback statute, the Stark law, or the tax laws has not had many judicial or administrative decisions addressing strictly appraisal issues. Increasingly, however, more decisions are emerging relating to the con-

cept of FMV.⁴⁸ The following is a summary of key judicial decisions involving valuation issues that should guide an appraiser's analytical framework in a business combination or other type of financial arrangement in a regulatory context.

1. The essential issue in *Goodstein v. McLaren*⁴⁹ involved the FMV of an office lease.⁵⁰ According to the complaint, false claims were submitted because McLaren (the hospital) was paying an excessive amount of rent to compensate physicians for patient referrals. A federal district court ruled against the government's claims, finding that the terms of the lease did not violate either the Stark law or anti-kickback statute because the payments were part of an arm's length transaction, were set at FMV, and did not reflect the volume or the value of the physician's referrals.

The *McLaren* decision is notable to appraisers for several reasons. In its opinion, the court stresses the overriding importance of arms-length negotiations between the parties. The opinion contains an extensive analysis of the McLaren lease negotiations and terms. Even though the court found the defendant's expert valuation analysis useful, the actual negotiations between the parties were afforded more significance in determining whether FMV was paid. The court's analysis is also especially noteworthy because of its thorough consideration of the issues surrounding FMV, despite the subject business interest involving a lease.

More recently, however, the U.S. Third Circuit Court of Appeals in *United States ex rel. Kosenske v. Carlisle HMA, Inc. et al.* restricted the interpretation of the *McLaren* opinion, holding that the fact that the parties had negotiated the terms of a contract was not enough to satisfy the FMV requirement under the Stark law; written agreements covering all items and services also should be considered a determinant of FMV. The decision in *Ko-*

senske, combined with the elimination of the FMV benchmarks for compensation arrangements under Stark, highlights the importance of adequately documenting the negotiation process and organizational merits of a business combination or other financial arrangement, including an appropriate appraisal to support the FMV conclusion.

2. The final decision in *Caracci v Commissioner* was written by the Fifth Circuit Court of Appeals⁵¹ and provides an appraiser with meaningful guidance on valuation methodologies involving tax-exempt organizations. *Caracci* was the first brought by the IRS to the Tax Court to impose intermediate sanctions for alleged excess benefits under the tax laws. The central issue in this dispute was the FMV of the assets of an exempt home health care agency (“Sta-Home”) in rural Mississippi upon conversion to a Sub-Chapter S corporate structure from a Section 501(c)(3) organization.⁵² The IRS alleged the taxpayers received a “net excess benefit”, *i.e.*, equity, totaling approximately \$18.5 million as a result of the conversion of Sta-Home.⁵³ The Tax Court affirmed the finding that the conversion resulted in a “net excess benefit” but reduced the amount of the benefit to \$5.1 million.⁵⁴ In arriving at its decision, the Tax Court adopted the IRS methodology of valuing Sta-Home’s market value of invested capital (MVIC).⁵⁵ The underlying idea advanced by the Tax Court is that once MVIC is established, accounting principles could be used to infer the FMV for Sta-Home’s net assets.

Upon appeal, the Fifth Circuit determined that the Tax Court made a number of errors in the valuation method it selected and in the facts it found in selecting and applying that method. The Tax Court’s use of an MVIC valuation method for valuing Sta-Home’s assets, particularly its intangible assets, was wrong as a matter of law.⁵⁶ MVIC is a measure of the aggregate value of a company’s debt

and equity securities, not its assets. The Tax Court used MVIC to do a general and indirect valuation of Sta-Home’s assets, thereby avoiding the problem of identifying and attaching a value estimate to each individual asset. The opinion is a sharply worded reminder to appraisers of the importance of using the appropriate valuation framework; for example, a MVIC methodology is not a legitimate asset valuation approach. Rather, the Fifth Circuit in *Caracci* relied upon an adjusted balance sheet approach to valuation, a methodology also endorsed by the Tax Court in *Anclote Psychiatric Ctr. Inc. v. Commissioner*⁵⁷ and in *Bradley J. Bergquist, et al. v. Commissioner*.⁵⁸

While the opinion written by the Fifth Circuit in *Caracci* represents an excellent roadmap for appraisers and attorneys, the foundation of the Court’s decision leaves a great deal of uncertainty surrounding the valuation of intangible assets of a 501(c)(3) organization. The Fifth Circuit ruled that Rev. Rul. 59-60 “requires the IRS to assign zero value to unprofitable intangible assets” and asserted that “unprofitable intangible assets do not contribute to fair market value unless those assets produce net income or earnings.”⁵⁹ This appears to be a very “facts and circumstances” based interpretation of Rev. Rul. 59-60, as numerous for-profit and not-for-profit companies with no earnings have been sold for huge sums of money, usually for a company’s patents, know-how, or other intangible assets. The juxtaposition of *Caracci* with the empirical market evidence suggests that appraisers should be very cautious with the Court’s view of intangible asset valuation.

3. The anti-kickback statute potentially applies in any sale or lease between a physician and a medical facility. In a leading case applying the anti-kickback statute, *Greber*,⁶⁰ the court found that the statute prohibited any financial incentives to physicians that might induce unneeded

services and that "...if one purpose of the payment is to induce future referrals, the anti-kickback statute has been violated."⁶¹ Simply stated, any payment for a referral, whether it is tangible or intangible, in-cash or in-kind, is illegal. Attempts to disguise such payments as a management service agreement, office or equipment lease, equity buy-in agreement, or some other form of legitimate remuneration does not change the purpose. The *Greber* one purpose test has been adopted by the courts in *United States v. Bay State Ambulance and Hospital Rental Service, Inc.*⁶² and *United States v. Kats*,⁶³ among others.

4. In *Bradley J. Bergquist, et al. v. Commissioner*,⁶⁴ the Tax Court rejected the claims of a group of physician shareholders to tax benefits from donated medical practice stock. At issue was the appropriate premise of value and the information an appraiser should consider in making a value estimate. Although not determined under either the Stark, anti-kickback, or intermediate sanctions thresholds, the court's focus on the correct premise of value and other key appraisal concepts⁶⁵ makes the guidance provided by *Bergquist* an important opinion for appraisers working with tax-exempt organizations on business combinations or other professional service arrangements. In *Bergquist*, physician shareholders took charitable contribution tax deductions⁶⁶ on shares of stock in their medical practice, which they donated approximately three months⁶⁷ in advance of consolidating their medical practice operations with another legal entity. Under the terms of the consolidation the physicians were to leave their medical practice and become employees of a newly formed tax-exempt professional services corporation;⁶⁸ the physician's previous medical business would remain simply to collect the accounts receivable outstanding as of the date of consolidation.⁶⁹ In subsequent tax filings, the physician shareholders reported the gift of stock deduction at \$401.79 per share while

the donee of the stock shares recorded the value at zero.⁷⁰ The IRS contested the valuation reported by the physicians.

At trial, the IRS' expert estimated the value of the donated shares to be \$37.0 and \$35.0 per share for the voting and non-voting shares, respectively.⁷¹ The dramatic difference between the IRS expert's appraised values and the opinion of \$401.79 per share provided to physicians stemmed largely from each experts' respective conclusions as to the *going concern* status of the physician practice enterprise. The Tax Court considered the issue of the appropriate premise of value within the context of a "willing buyer and a willing seller" framework. Although typically not considered, subsequent events that are reasonably foreseeable may be of value in determining the appropriate premise of value.⁷²

On the evidence, it was clear to the Tax Court that the physician shareholders would not have donated their shares of stock if much uncertainty existed about the prospects for the consolidation.⁷³ Without any realistic possibility that the consolidation of medical operations would not occur as planned, the physician shareholders' appraisal was deemed invalid since a willing buyer of the shares of stock obviously would know the operations of the enterprise would cease to be a *going concern* upon the impending consolidation. Therefore, the Tax Court ruled that the physician's valuation of \$401.79 per share was based entirely on an incorrect valuation premise⁷⁴ resulting in a gross valuation misstatement.⁷⁵ Rather than *going concern*, the Tax Court determined the appropriate paradigm should have been FMV *in place as a mass assemblage of assets*.⁷⁶ In other words, what is likely to happen to the business beyond the valuation date makes a difference in how an appraiser should pair the standard of FMV with the appropriate premise.

Programs to increase enforcement actions in the health care sector have been announced by both the IRS and CMS, which should provide additional guidance to valuation issues involving financial arrangements with charitable entities. In 2004, the IRS announced plans to contact hundreds of tax-exempt organizations regarding the compensation paid to their highest paid employees. The IRS also confirmed that it will be reviewing transactions reported on the Form 990 by Section 501(c)(3) and 501(c)(4) tax-exempt organizations as “excess benefit transactions.”

More recently, CMS announced in 2007 that it would be collecting comprehensive information about ownership and compensation arrangements from 500 hospitals under a new “Disclosure of Financial Relationships Report (DFRR).”⁷⁷ CMS indicated that it intended to use this information to investigate compliance with the Stark law although it is not clear at this point whether the DFRR will be implemented or scaled back to target only a smaller group of hospitals in the future. These recent initiatives clearly signal a new wave of enforcement actions that likely will entangle those individuals, including appraisers,⁷⁸ who violate the regulatory boundaries of FMV.

COMPLIANCE WITH THE FAIR MARKET VALUE FRAMEWORK

As discussed throughout this article, the appraisal framework for determining FMV in the health care industry is becoming increasingly important and complex. Appropriately structured valuations are crucial protection for health care organizations to ensure compliance with regulatory requirements and to evaluate potential business opportunities.⁷⁹

For health care organizations to maximize the value of a business valuation, it is important to integrate the compliance aspect of the analysis with its own business planning processes. Coordination of these aspects early in the process allows for consideration of how the regulatory framework may impact the final computation of FMV.

A regulatory review of a business combination or compensation arrangement puts all parties at a level of risk. To demonstrate compliance with the FMV standard, administrative rulings and court decisions have focused on several key considerations.

Rebuttable Presumption

The IRS’ intermediate sanction regulations state that a compensation arrangement or business combination between a tax exempt organization and a disqualified person is presumed to be reasonable or at FMV if specific conditions are satisfied.⁸⁰ Thus, if an exempt organization can demonstrate that it exercised care and prudence in the decision-making process relating to a transaction with a disqualified person, and follows the requisite steps to invoke the rebuttable presumption, then the IRS bears the burden of showing that the transaction is unreasonable.

One action a fiduciary can take to exercise care and prudence is to commission a contemporaneous appraisal to support management’s decision making. “Care and prudence,” however, does not imply that management can “blindly rely” on the results of a contemporaneously commissioned appraisal, especially one that is based on an “unreasonable” assumption, as was at issue in *Bergquist*.⁸¹ Rather, thoughtful decision making is required when establishing a position of rebuttable presumption.

The *Caracci* opinion highlighted the importance of appropriate actions by fiduciaries when establishing a rebuttable presumption, noting among other proper actions taken by the Caracci’s that they had obtained two independent appraisals prior to transferring assets from an exempt entity to a for-profit corporation.⁸² A determination of reasonableness is equally important, if not more so, when executive compensation is established. In both instances, having a contemporaneous valuation performed will aid a not-for-profit organization in qualifying for the rebuttable presumption that the transaction reflects FMV.

Qualifications of the Appraiser

The selection of a valuation consultant who has significant industry experience as well as the appropriate valuation credentials is an important part of any business transaction or compensation arrangement in the health care industry, especially if the appraiser is later required to provide expert testimony. The federal courts have progressively strengthened the admissibility standards for expert witness testimony.⁸³ Starting with *Daubert v. Merrell Dow Pharmaceuticals*,⁸⁴ several cases have demonstrated an increasing intolerance for alleged scientific experts offering unfounded opinions; several trial courts (and appeals courts) have applied *Daubert* to exclude valuation-related testimony.⁸⁵

The findings in *Caracci* relied heavily on the effort and experience of the Caracci's valuation expert. The Fifth Circuit recognized the national reputation of the Caraccis' expert in the home health care industry and the significance of the eight weeks he spent onsite with management of Sta-Home "studying the assets and liabilities transferred in the conversion and analyzing the home-health care industry in the area."⁸⁶

While valuation experts in *Caracci* had substantial valuation experience and the appropriate professional credentials, the Fifth Circuit noted that the IRS' valuation expert "had no prior experience with the home health care industry."⁸⁷ Although it did not invoke the principles contained in *Daubert* explicitly, the Fifth Circuit voiced skepticism⁸⁸ concerning the qualifications of the IRS' valuation expert to render a cogent opinion of value. Likewise, the recent decision in *Bergquist* highlights the importance of a qualified appraiser and a well-prepared valuation analysis to determine FMV:

Petitioners have not pointed to, nor do we find, significant flaws in respondents expert analysis or in the studies he relied upon that would suggest his report is unreliable, and we adopt respondent's expert's discounts and conclusion of value.⁸⁹

Documentation

Although an independent appraisal is not required to support the terms of a transaction, CMS indicates that internally developed valuation methods are susceptible to manipulation and may be subject to more intensive scrutiny.⁹⁰ The importance of using an independent valuation expert to assist in determining FMV cannot be ignored.⁹¹ Engaging a valuation expert early in the process can help document management's decision making throughout the weeks or months of time that elapses until a transaction is closed. An appraiser often will provide documentation in two separate forms: (a) preliminary analyses that assist management's decision making during the course of negotiations, and (b) a complete valuation opinion that reflects the final terms of the transaction.

Preliminary analyses are typically in the form of draft schedules and can vary widely in their presentation of results due to changes in the negotiation process. The final valuation documentation, however, is relatively stable in its compliance requirements, dictated primarily by the final terms of the transaction, the regulatory framework, and the Uniform Standards of Professional Appraisal Practice (USPAP).⁹² USPAP represents the generally accepted and recognized standards of appraisal practice.

While USPAP does provide a minimum set of quality control standards for the conduct of appraisal, it does not attempt to prescribe specific valuation methods to be used: USPAP simply requires that appraisers correctly utilize those methods which would be acceptable to other appraisers familiar with the assignment at hand and acceptable to the intended users of the appraisal. As such, USPAP's intent does not put it in conflict with the Stark law, anti-kickback law, or "intermediate sanctions" regulations but, instead, reinforces the principles described in the definition of "general market value."

The IRS continues to place a premium on adequate documentation and a reason-

able approach to structuring transactions involving not-for-profit organizations. It is helpful upon a regulatory review of a business combination or financial arrangement for the supporting appraisal report to conform to the following guidelines:

- The standard and premise of value, subject business interest, and valuation date must be identified. There should be a comprehensive description of the transaction that demonstrates the appraiser understands the facts and circumstances.⁹³ The appraiser's opinion of FMV should reference the applicable regulatory thresholds upon which the conclusion is based.
- Inclusion of a "synthesis of value" section in the report that explains the methodology and approaches the appraiser used, data relied upon, and relevant consideration applied to the unique circumstances of the transaction provides justification for the overall opinion. The conclusion should be presented as specifically as possible; it is always important to provide clarity to the conclusion by disclosing *all* calculations in the supporting schedules.
- The appraisal opinion must be developed in conformance with USPAP.⁹⁴ These comprehensive business valuation standards require the appraisal document to be developed in accordance with the principles of independence, ethics, and competence as reflected by the overall appraisal document in its entirety. A USPAP-compliant document greatly minimizes the potential for a successful *Daubert* challenge if defense of the transaction is later required.

CONCLUSION

During the past several years there has been an increase in the level of business arrangements in the health care industry after a long period of dormancy. This has created the need for more compliance-driven appraisal opinions due to heightened government regulatory concerns

over FMV transactions. Since the last wave of consolidation activity in the health care services industry during the 1990s, several important legal decisions such as *Caracci*, *Bergquist*, and *Derby* have been rendered by the Courts, providing all parties to a potential transaction with some important guidance on valuation issues surrounding the standard of FMV. These legal decisions provide the appraiser with "points on a curve," reflecting a wide range of key valuation considerations in transactions involving health care providers and tax-exempt organizations.

While these judicial decisions are helpful to health care appraisal practice in general, many of the valuation issues addressed in these opinions stemmed from the now antiquated M&A development model so prevalent in the health care services industry during the 1990s. Today, with the additional resource constraints and fund balance erosion experienced by many tax-exempt health care organizations, the standard of FMV increasingly is finding its way into areas involving complex management service agreements and personal service arrangements, creating a different set of valuation issues that are not yet addressed by the current case law. As such, appraisers will have to continue to adapt and adjust to the complex and constantly evolving legal framework of FMV in the health care services industry.

Endnotes:

1. 501(c) is a provision of the U.S. Internal Revenue Code (26 U.S.C. §501(c)), listing 26 types of nonprofit organizations exempt from some federal income taxes; §501(c)(3) describes eight of the most common types of exempt organizations. These eight exempt organizational types are often collectively or generically referred to as charitable organizations. To qualify for tax-exempt status under IRC §501(c)(3), an organization must be both "organized" and "operated" exclusively for one or more purposes specified in that section. If the organization fails to meet either the organizational or operational tests, it is not exempt.
2. In addition to federal program requirements imposed by Medicare and Medicaid, many states have enacted comparable statutes and regulatory provisions governing relationships with other,

- nonfederal payors as well (so-called “all-payor” provisions).
3. “When considering the question of fair market value, we would note that the traditional or common methods of economic valuation do not comport with the proscriptions of the anti-kickback statute. Items ordinarily considered in determining the fair market value may be expressly barred by the anti-kickback statute’s prohibition against payments for referrals. Merely because another buyer may be willing to pay a particular price is not sufficient to render the price to be paid fair market value. The fact that a buyer in a position to benefit from referrals is willing to pay a particular price may only be a reflection of the value of the referral stream that is likely to result from the purchase.” Letter from D. McCarty Thornton, Associate General Counsel, Office of Inspector General (HHS) to T.J. Sullivan, Technical Assistant, office of the Associate Chief Counsel, Employee Benefits and Exempt Organizations, December 22, 1992.
 4. In a recent case, *Bradley J. Bergquist et al. v. Commissioner*, 131 T.C. No. 2 (2008), each physician taxpayer was assessed a 40 percent accuracy penalty for a *gross valuation misstatement* as a result of the appraiser’s opinion, resulting in taxes, penalties, and interest totaling more than \$100,000 for each physician.
 5. 42 U.S.C. §1320a-7b(b).
 6. See 42 U.S.C. §1320a-7b(b)(1), (2); Omnibus Budget Reconciliation Act of 1993, 13562, 107 Stat. 312 (1993); and IRS CPE text, at pp. 173-75.
 7. Financial Accounting Series Statement of *Financial Accounting Standards No. 141 (revised 2007): Business Combinations*; Financial Accounting Standards Board of the Financial Accounting Foundation released December 2007. This Statement retains the guidance in SFAS 141 for identifying and recognizing intangible assets separately from goodwill.
 8. Congress included a provision in the Omnibus Budget Reconciliation Act of 1989 (OBRA 1989) which barred self-referrals for clinical laboratory services under the Medicare program, effective January 1, 1992. This provision is known as Stark I. OBRA 1993 expanded the restriction to a range of additional “designated health services;” this legislation became known as Stark II. Note that Stark reaches Medicaid referrals only indirectly — that is, services rendered pursuant to Medicaid referrals that would otherwise be impermissible under Stark’s Medicare provisions are not eligible for federal matching funds, but there is no direct penalty to the physician provider.
 9. Similarly to the anti-kickback statute, the Stark law qualifies fair market value in ways that do not necessarily comport with the concepts in standard valuation analyses. For example, the Stark law specifies that valuation methods must exclude market “comparable” data where the parties to the transaction are at arm’s length but in a position to refer to each other. See 69 Fed. Reg. 16107.
 10. Rev. Rul. 69-545, 1969-2 C.B. 117 establishes the “community benefit standard” for the exemption of health care providers and focuses on a number of factors indicating that the operation of a hospital benefits the community rather than serving private interests.
 11. 26 C.F.R. §53.4958-1T. Although the concept of private inurement lacks precise definition, the intent is a prohibition against transactions that enrich insiders who are in a position to exercise control or influence over tax-exempt organization.
 12. *Birmingham Bus. College, Inc. v. Commissioner*, 276 F.2d 476, 479 (5th Cir. 1960).
 13. Although the statutory definition of “disqualified person” is not necessarily synonymous with the notion of an “insider” of the organization under the private inurement doctrine, in general, it may be a rare case where a person who satisfies the definition of a disqualified person is not also considered an insider, and vice-versa.
 14. IRS investigations into the conduct of an exempt entity typically focus on the inappropriate use of charitable assets, resulting in private benefit or inurement. In the past, major enforcement actions involving appraiser conduct usually have resulted from the improper valuation of assets for those deemed to be designated insiders.
 15. *Harding Hospital, Inc. v. United States*, 505 F.2d 1068, 1072 (6th Cir. 1974); *World Family Corp. v. Commissioner*, 81 T.C. 958, 969 (1983) (stating that the law “places no duty on individuals operating charitable organizations to donate their services; they are entitled to reasonable compensation for their efforts”). Whether compensation is reasonable is a question of fact. *Founding Church of Scientology v. United States*, 412 F.2d 1197, 1200 (Ct. Cl. 1969), cert. denied, 297 U.S. 1009 (1970).
 16. *Texas Trade School v. Commissioner*, 30 T.C. 642 (1958), *aff’d* 272 F.2d 168 (5th Cir. 1959).
 17. *Sonora Community Hospital v. Commissioner*, 46 T.C. 519, 526 (1966), *aff’d* 397 F.2d 814 (9th Cir. 1968). The court found that the hospital was operated for the private benefit of two founding doctors, who previously had owned hospital facilities and who shared in the fees from a privately operated laboratory and x-ray business within the hospital even though they performed no associated services.
 18. “*Caracci and Valuation in a Tax Status Conversion*,” *Business Valuation Review*, Vol. 26, No. 4, p. 121.
 19. IRS Ruling 59-60, 1959-1 C.B. 237.
 20. See www.cms.hhs.gov/physicianreferral.
 21. In 2004, CMS noted that valuation methodologies under Stark law “must exclude valuations where the parties to the transaction are at arm’s-length but in a position to refer to each other.”
 22. The regulatory exceptions to the Stark law — just like the regulatory “safe harbors” to the anti-kickback statute (see 42 C.F.R. 1001.952 et seq.) — create narrowly defined exceptions to the Stark law’s prohibitions for certain arrangements that CMS has determined pose a minimal risk of improper referral

- practices or overutilization.
23. Sec. 1877 [42 U.S.C. §1395nn].
 24. 42 U.S.C. §1395nn(h)(3) (2006).
 25. 42 C.F.R. §411.351 (2006).
 26. In general, these attributes are enunciated by the IRS in Revenue Ruling 59-60.
 27. *Estate of Bright v. United States*, 658 F.2d 999, 1006-1007 (5th Cir. 1981).
 28. The valuation methodology must reflect the attributes of the entity whose assets are being valued. *Caracci*, 456 F.3d at 456 (citing *Estate of Dunn v. Comm'r*, 301 F.3d 339, 356-357 (5th Cir. 2002)).
 29. Financial Accounting Standards Board Statement of Financial Accounting Standards No. 157 (SFAS 157), "Fair Value Measurement" released September 15, 2006.
 30. *Id.* SFAS 157 clarifies that the exchange price for a subject asset is the price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability. In many respects, the concept of fair value for financial reporting and the investment value standard are similar perspectives as they both channel the appraiser to search for the highest price in the most advantageous market.
 31. A value represents fair market value only if it reflects assumptions accepted by a consensus of market participants. Investment value is the result of economic assumptions of a particular buyer. See Pratt, Shannon P., "Valuing a Business: the Analysis and Appraisal of Closely Held Companies" Dow-Jones Irwin (Homewood: Illinois) 1989, pg. 25.
 32. Pratt, Shannon P., "Valuing Small Businesses and Professional Practices" Business One Irwin (Homewood: Illinois) 1993, pg. 248.
 33. *Id.* at 248.
 34. For example, see In *Bradley J. Bergquist et al. v. Commissioner*, 131 T.C. No.2 (July 22, 2008). The Tax Court rejected an inflated appraisal on a charitable gift of stock and assessed back taxes and substantial penalties. The court noted that the "expert valuations are based entirely on an incorrect valuation premise."
 35. The premise of a *going concern* also applies in situations in which the 501(c)(3) entity is attempting to change its tax status. See Hahn, Allen D., "Caracci and the Valuation of Exempt Organizations," *Journal of Health Law*, Spring 2007, Volume 40, No. 2.
 36. 63 Fed. Reg. 1700 (Jan. 9, 1998).
 37. 69 Fed. Reg. 16107 (March 6, 2004).
 38. The required filings of publicly traded companies with the SEC are available at www.Edgar.gov; IRS Form 990 for tax-exempt entities can be found at www.guidestar.com.
 39. There are many text books that examine the different theories of capital budgeting, including decision making rules using internal rates of return (IRR), net present value (NPV), and weighted average cost of capital (WACC), among others. For an in depth discussion of capital budgeting, see *Capital Budgeting: Theory and Practice* (Pamela P. Peterson and Frank J. Fabozzi).
 40. "Halo" cash flows are peripheral to the stream of direct cash flows from an investment in a project. These secondary cash flow streams materialize as a direct necessity of generating the project cash flows, making them almost inseparable from the primary cash flow stream. For example, prior to a procedure performed on a Gamma Knife (primary cash flow stream) a patient is required to undergo a series of medical tests (secondary or "Halo" cash flows) to prepare for the intended Gamma Knife procedure.
 41. "Reasonableness" is an issue that has posed problems for the courts because it is not a concept that easily lends itself to preciseness of measurement.
 42. 26 C.F.R. §1.162-7(b)(3).
 43. Compensation includes all forms of payments and benefits provided to those who provide services to a tax exempt organization, including salary and wages, pension and profit sharing contributions, deferred compensation, payment of personal expenses, fringe benefits, rents, royalties and other fees, personal use of tax-exempt assets or transfers of noncash property.
 44. 72 Fed. Reg. 51015 (Sept. 5, 2007).
 45. 66 Fed. Reg. 856 at 944 (Jan. 1, 2001).
 46. A good source of compensation data for physician medical and clinical services can be found on IRS Form 990, Return of Organization Exempt from Income Tax. See, for example, www.guidestar.org.
 47. Under a normal distribution, two standard deviations from the mean will encompass approximately 95.0 percent of all data observations. An observation that exceeds this threshold, either greater or less than, is then likely to be considered an extraordinary occurrence and possibly subject for further investigation.
 48. See, for example, Settlement Agreement Among the United States of America and Beebe Medical Center, Richard Caruso, MD and Vinod Parasher, MD, effective as of March 13, 2006; Settlement Agreement Among the Office of Inspector General, Department of Health and Human Services and Lincare Holdings Inc. and Lincare Inc., effective as of May 15, 2006 and *United States ex rel. Orbeck v. Marion County Med. Ctr.*, No. 3:04-cv-22599 (D.S.C. July 18, 2006).
 49. *United States ex rel. Goodstein v. McLaren Regional Medical Center*, 202 F. Supp. 2d 671 (E. D. Mich. 2002).
 50. *Id.* at 672-73.
 51. *Caracci v. Comm'r*, 456 F.3d (5th Cir. 2006); *Caracci v. Comm'r*, 118 T.C. (2002). A copy of both court decisions and Mr. Hahn's article "Caracci and the Valuation of Exempt Organizations," *Journal of Health Law*, Spring 2007, Volume 40, No. 2. are available at www.adhadvisors.com.
 52. *Id.* at 382, 390-91.
 53. The deficiency notices given to the Caracci family were not based on a final economic report, instead using the figure from the "intermediate determination of value" to compute a net excess benefit of \$18.5 million and trigger excise taxes and penalties of over \$250 million.
 54. *Caracci*, 118 T.C. at 413.
 55. *Id.* at 405.

56. *Caracci v. Comm’r*, 456 F.3d 461–462 (5th Cir. 2006).
57. *Anclote Psychiatric Ctr. v. Comm’r*, 76 T.C.M. (CCH) 175 (1998).
58. *Bradley J. Bergquist, et al. v Commissioner*, 131 T.C. No. 2 (2008).
59. See *Caracci*, 456 F.3d at 461.
60. *United States v. Greber*, 760 F.2d 68 (3d Cir. 1985), cert. denied 474 U.S. 988 (1985).
61. *Id.* at 69.
62. *United States v. Bay State Ambulance and Hospital Rental Service, Inc.*, 874 F.2d 20, 2930 (1st Cir. 1989).
63. *U.S. v. Kats*, 871 F.2d 105, 110 (9th Cir. 1989).
64. *Bradley J. Bergquist, et al. v Commissioner*, 131 T.C. No. 2 (2008).
65. The Tax Court accepted the IRS expert report without adjustment. In doing so, the court allowed a 45.0 percent discount on the physician’s donated stock for a lack of marketability that was largely supported by pre-IPO studies. Such studies were rejected *en banc* in *McCord v. Commissioner*, 461 F.3d 614 (5th Circuit 2006), and this decision may provide an opportunity for the renewed support for these studies to support appropriate discounts for lack of marketability in valuing non-controlling interests in private companies.
66. See *Derby v. Commissioner*, T.C. Memo. 2008-45. A recent Tax Court opinion involving physicians in the charitable donation of intangible property and subsequent favorable challenge of the valuation of the gift donation by the IRS.
67. *Bradley J. Bergquist, et al. v Commissioner*, 131 T.C. No. 2 12-14 (2008).
68. *Id.* at 6.
69. *Id.* at 10.
70. “Based on advice from our legal and accounting advisors, we are placing the total value of all of the donated shares at \$0 on our books. This net valuation is in recognition of the consensus pro-forma cash flow projections developed by [UA] for CY2002 and reviewed by OHSUMG staff. These financials indicate that, as the affairs of UA are wound up over the next year, total projected cash disbursements will approximate total projected cash receipts, thus leaving no unencumbered residual value for the benefit of OHSUMG.” *Id.* at 12-13.
71. *Id.* at 17.
72. In *Estate of Gilford v. Commissioner*, 88 T.C. 38, 52 (1987), property is valued as of the valuation date “on the basis of market conditions and facts available on that date without regard to hindsight” and subsequent events “are not considered to fix fair market value, except to the extent that they were reasonably foreseeable at the date of valuation.” *Trust Servs. Of Am., Inc. v United States* 885 F.2d 561, 569 (9th Cir. 1989). The *Bergquist* court, however, also reminded appraisers that events that are reasonably foreseeable must be considered in arriving at an estimate of fair market value “because they would be foreseeable by a willing buyer and willing seller, and they therefore would affect the valuation of the property.” *Estate of Gimbel v. Commissioner*, T.C. Memo. 2006-270.
73. *Bradley J. Bergquist, et al. v Commissioner*, 131 T.C. No. 2 19 (2008).
74. *Id.* at 19.
75. *Id.* at 26. “Under section 6662(h) a taxpayer may be liable for a 40 percent accuracy-related penalty on the portion of an underpayment of tax attributable to a *gross valuation misstatement*” (emphasis added).
76. *Id.* at 23. The essential difference was that the physicians’ appraisal was based on the premise that the medical practice was a going concern while the IRS expert recognized the fact that the medical practice would cease operations at or near the date of the stock donation. The IRS’ expert used an asset-based approach to arrive at his estimate of value, which is consistent with this premise of value.
77. 72 Fed. Reg. 52568.
78. See Gasiorowski, John R., ASA “Internal Revenue Code Penalties Applicable to Appraisers Have Been Expanded” *Business Valuation Review*, Vol. 28, No. 1 pgs. 3-7, (Spring 2009).
79. An initial review of a valuation report can be aided by “Chapter 25-Checklist for Reviewing a Business Valuation Report” *Business Valuation Review* Vol. 28 No. 2 pg. 110. This checklist is free from copyright restrictions and provides a good framework for either an overview or in-depth evaluation of an appraisal report.
80. See 26 C.F.R. 53.4958-6(a).
81. *Bradley J. Bergquist, et al. v Commissioner*, 131 T.C. No. 2 28 (2008) citing *Kellahan v Commissioner*, T.C. Memo. 1999-210; *Estate of Goldman v. Commissioner*, T.C. Memo. 1996-29.
82. *Caracci*, 456 F.3d at 449, 451. Both appraisals concluded that the liabilities of Sta-Home exceeded its tangible and intangible assets, suggesting the potential for insolvency.
83. PricewaterhouseCoopers’ recent “2000-2007 Financial expert witness Daubert challenge study” examined 3,681 *Daubert* challenges to expert witnesses of all types in federal and state courts during the years 2000-2007 and found that “the number of per-year challenges rose from 251 in 2000 to 704 in 2007, an overall increase in spite of a slight dip in the number of challenges between 2006 and 2007 — 741 challenges in 2006 (an all-time high) versus 704 challenges in 2007.” PricewaterhouseCoopers LLP, August 2008, www.pwc.com/daubertstudy.
84. *Daubert v. Merrell Dow Pharmaceuticals*, 509 U.S. 579, 597-598 (1993).
85. In *Andrew J. Whelan, et al. v. Tyler Abell, et al.*, (U.S. District Court, District of Columbia, Civil Action Nos. 87-442 and 87-1763) the judge excluded the financial valuation expert testimony of a PricewaterhouseCoopers partner, Hugh Penny, CPA. In *Frymire-Brinati v. KPMG Peat Marwick*, 3F.3d 183 (7th Circuit, 1993) the Court of Appeals excluded the testimony of another CPA valuation expert. See also *Target Mkt. Publ’g, Inc. v. ADVO, Inc.*, 136 F.3d 1139, 1144 (7th Cir. 1998) (upholding exclusion of business appraiser’s report under *Daubert* due to an “analytical gap” between the data and the expert opinion offered). Lastly, *MDG International v. Australian Gold, Inc.*, 2009 WL 1916728 (S.D. Ind. June

- 29, 2009) is a very recent example on how a highly qualified appraiser's opinion can fail to satisfy *Daubert* for reliability and admissibility at trial.
86. *Caracci*, 456 F.3d at 451.
87. *Id.* at 451.
88. This lack of industry experience resulted in a series of "significant errors in his analysis." *Id.* at 447. Accordingly, the *Caracci* court concluded: "[t]he [IRS] presented an expert who used an inappropriate valuation method and lacked basic factual information essential to the asset valuation he was called on to provide." *Id.* at 462.
89. *Bradley J. Bergquist, et al. v Commissioner*, 131 T.C. No.26 (2008).
90. See generally 66 Fed. Reg. 944-46. (Jan. 4, 2001).
91. *Id.* at 945.
92. The Federal Institutions Reform, Recovery and Enforcement Act (FIRREA) required real estate appraisals used in connection with federally funded projects be conducted according to USPAP. Later, USPAP was extended to business appraisals by Congress in the Pension Protection Act of 2006 (PPA).
93. *Derby v. Commissioner*, T.C. Memo. 2008-45; the decision in *Derby* reaffirms that valuation analysis in the context of a transaction in the health care services industry requires the appraiser to consider all relationships among the parties to the transaction and all relevant terms of the deal.
94. In addition to the authority bestowed by federal law, USPAP business valuation standards have been recognized in federal courts and increasingly in the state courts as a minimum standard to qualify a business valuation report. See *Kohler et al. v. Commissioner* T.C. Memo. 2006-152 where an expert's valuation report was dismissed from evidence by the court because it was not "prepared in accordance with all USPAP standards" and lacked "the customary USPAP certification" regarding compliance with those standards.

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