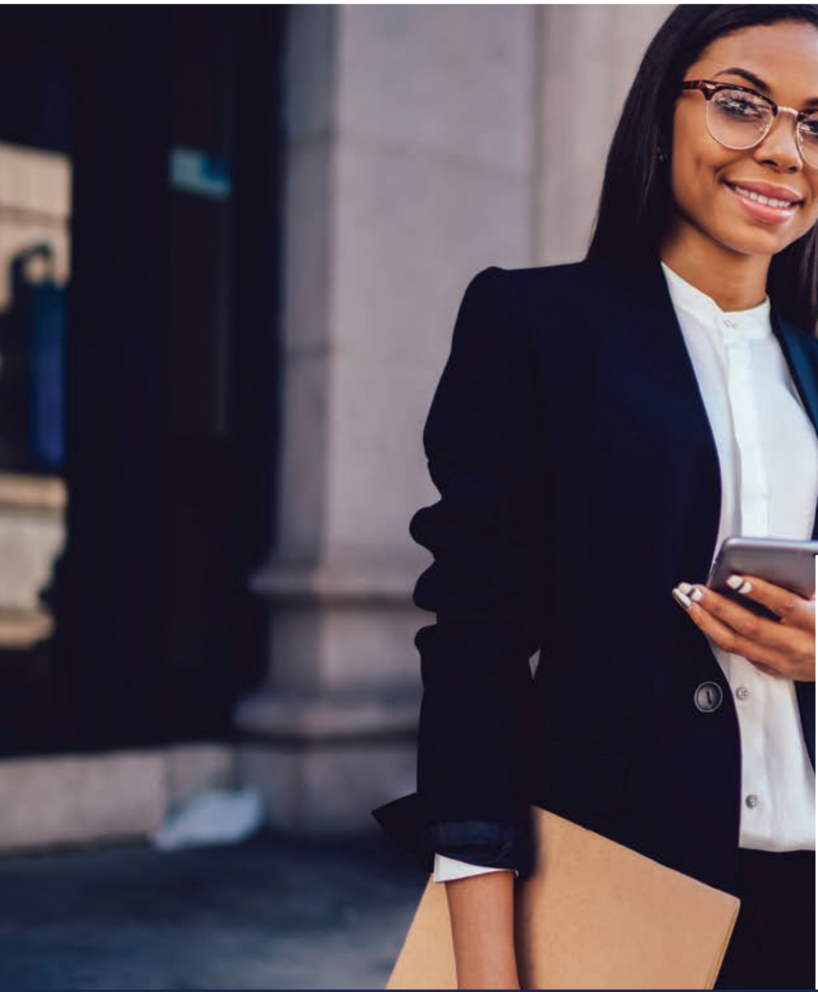
MAY/JUNE 2020

ADVOCATE'S EDGE



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Estate and gift tax valuations

3 valuable lessons from the trenches

The IRS and taxpayers rarely see eye-to-eye when valuing businesses for estate and gift tax purposes. Here's a summary of three recent developments from the U.S. Tax Court, a federal district court and the IRS Office of Chief Counsel that deal with the issue of fair market value in a federal estate and gift tax context.

1. *Cavallaro v. Commissioner*

Cavallaro highlights how inaccurate inputs can skew a valuation expert's conclusion. The Tax Court heard this case on remand from the First Circuit Court of Appeals. It involved a tax-free merger of a couple's business with a related business that was owned by their sons. The IRS issued a deficiency notice, claiming that the sons' company had no premerger value. As a result, the transaction was deemed a taxable gift to the sons.

In the original trial, the Tax Court found gift tax deficiencies of $7.6 million for the father and $8 million for the mother, based solely on the IRS expert's valuation. On appeal, the parents argued that their burden was to establish that the alleged deficiencies were erroneous, not to show the proper amount of their tax liability. The Court of Appeals agreed, finding they had to show only that the IRS determination was "arbitrary and excessive." It remanded the case to give the taxpayers the opportunity to do so.

On remand, the Tax Court determined that the IRS expert had erred. Specifically, he assumed that the sons' company had achieved a profit margin in the 90th percentile of its industry, while its margin was actually in the 88.3rd percentile. The court ruled that this error overvalued the total disguised gift by $6.9 million, rendering the IRS valuation arbitrary and excessive.

2. *Carter v. United States*

Carter deals with whether it's appropriate to consider an event that happens *after* the valuation date. In this case, the personal representative for an estate took issue with the IRS's assessment of bank stock that constituted nearly half the estate's value. The estate contended that the IRS should have reduced the stock's exchange value to account for a massive criminal fraud committed against the bank by a customer. The estate valued the stock using the alternative valuation date (six months after the decedent's death) and argued it was worthless at that time.

In general, the average exchange price quoted on the valuation date provides the most accurate and readily ascertainable measure of a public stock's

Court holds firm on deadline for refund claim

In *Carter v. United States*, a federal district court rejected the executor's claim that the financial disability exception tolled the statute of limitations on the estate's refund claim. The tax code allows suspension of the filing deadlines while individuals are unable to manage their financial affairs due to a disability.

Taxpayers are considered "financially disabled" if they can't manage their financial affairs because of a medically determinable physical or mental impairment that either:

- Can be expected to result in death, or
- Has lasted or can be expected to last for a continuous period of at least 12 months.

Proof of impairment is required. The executor in *Carter* provided such evidence, but the court held that estates don't qualify as "individuals" subject to the financial disability exception. Although estates can conduct affairs only through personal representatives, the court ruled that they exist separately from those representatives.

fair market value. However, in *Carter*, the market for the bank stock didn't collapse until more than a year after the estate's valuation date.

In most jurisdictions, a valuation expert can only consider events that were "known or knowable" on the valuation date. In this case, a hypothetical investor would have had no way of knowing — on either the date of death or six months later — that a fraudulent action would eventually diminish or destroy the value of the bank's stock. The court ruled that, until the fraud was public knowledge and affected the exchange price, it didn't impact the stock's fair market value for tax purposes.

3. Chief Counsel Advice Memorandum 201939002

Some subsequent events should be factored into the valuation equation, however. In October 2019, the IRS issued guidance recommending that a pending merger be considered when valuing stock in a publicly traded company for gift tax purposes. The company announced the merger several days after the company's founder and chairman of the board gifted shares to a grantor retained annuity trust (GRAT). The announcement substantially increased the value of the stock.

The Chief Counsel found that, based on the record, the hypothetical willing buyer and seller of shares could have reasonably foreseen the merger and anticipated that the stock price would trade at a premium. The record included an exclusivity agreement between the merged companies, correspondence between them and board meeting minutes.

> In general, the average exchange price quoted on the valuation date provides the most accurate measure of a public stock's fair market value.

Stay tuned

Accurate stock valuations calculated by qualified appraisers can make a dramatic difference in tax outcomes. Discuss relevant case law and IRS guidance with your business valuation advisor *before* you devise an estate plan. ■

Filing charges against a fraudster

After occupational fraud has been discovered, some companies choose to quietly terminate the employee, hoping to cut the company's losses, preserve its reputation and move on with daily business operations. This option, while quick and inexpensive, can have negative long-term consequences. Most notably, it doesn't help the company recoup its losses, and it does nothing to prevent the criminal from stealing from other employers in the future. What's more, it sends a negative message to co-workers and can "poison" a company's culture.

Pursuing civil or criminal legal action is a more time-consuming and costly alternative. As a result, the Association of Certified Fraud Examiners (ACFE) estimates that only 23% of victims file civil suits against white collar criminals and only 58% refer their cases to law enforcement. But, over the long run, prosecuting a fraudster can provide a major upside: justice.

Civil vs. criminal

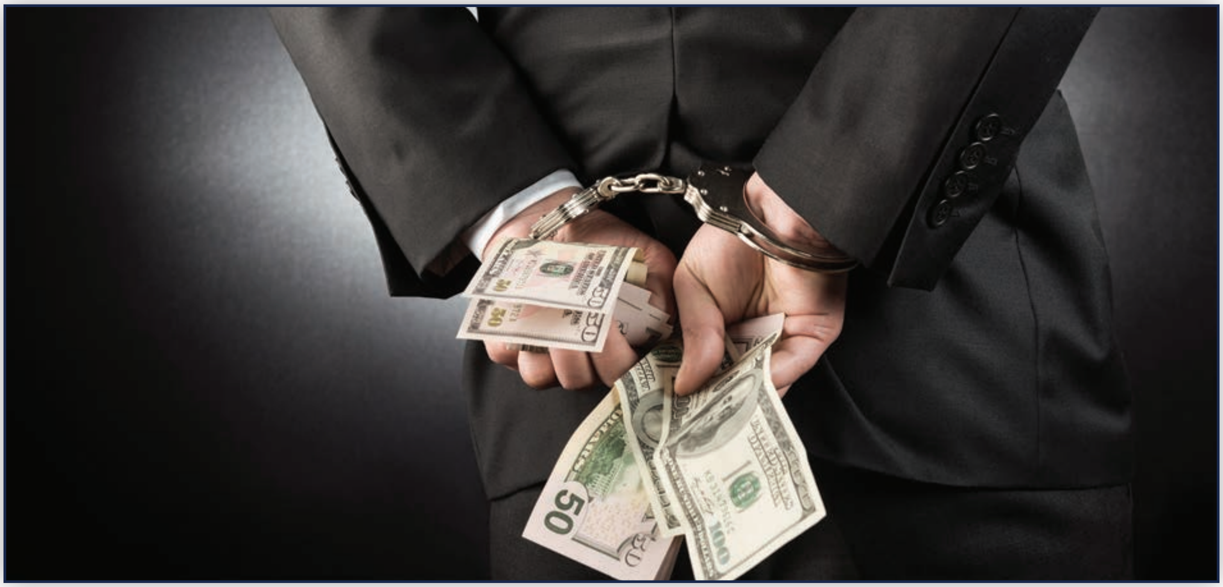
There are fundamental differences between a civil fraud case and a criminal one. The biggest difference is who's pursuing the legal action. In a civil case, the victim-organization files a lawsuit against the perpetrator, alleging intentional misrepresentation and financial gain and seeking recovery of damages. To pursue a civil case, the plaintiff must have incurred *actual damages*.

Conversely, criminal cases are filed by local, state or federal prosecutors, who must prove that the perpetrator *intended* to commit the misrepresentation and gain from it. These cases can be litigated even if the fraud wasn't successful and nobody was actually harmed. A successful criminal prosecution provides punishment for the wrongdoer, including possible incarceration, probation, fines and restitution to any victims that may have been damaged.

Team effort

Attorneys play a fundamental role in helping victim-organizations determine what's appropriate. They can also put clients in touch with the appropriate government agency if they decide to report the incident to law enforcement.

However, working with criminal prosecutors can sometimes be a frustrating experience — for both sides. To ensure that law enforcement receives



the support it needs to pursue a case, the victim-organization usually designates a primary contact person to answer questions and gather additional documentation as needed.

During a criminal fraud investigation, it's important to organize documents so they're easy to follow and avoid industry jargon. If the case is particularly complex, flowcharts or other visual media can help explain the theory behind how the funds were stolen. If in-house accounting personnel lack the time or resources to conduct this analysis or act as the point person — or if management suspects that the accounting department was involved in the fraud scheme — an outside forensic accounting expert can be hired to assemble the paper trail and investigate potential leads.

Depending on their caseloads, detectives or agents assigned to a case may ask to meet at off times, such as early in the morning or on weekends. So, the point person needs to be as accommodating as possible to help move the case forward.

Management's role

Note that the victim-organization doesn't make the decision about whether to prosecute an alleged fraud perpetrator. That call rests with the attorney general or another government prosecutor. Management's role is to facilitate the investigation, not conduct it or decide on its resolution.

> In order to pursue a civil case, the plaintiff must have incurred *actual damages*.

To that end, company personnel should be careful when interacting with the fraud suspect. Management should check with legal counsel if the case's lead detective asks them to participate in interviews of the alleged perpetrator or provide a list of questions to ask the perpetrator. Participating in a law enforcement interview or asking questions on behalf of law enforcement could violate an employee's constitutional rights and give rise to a "state action" claim.

Forensic expertise is key

When management suspects fraud, it's time to assemble a team of legal and financial advisors. The appropriate course of action depends on the facts of the case. A fraud expert can help investigate the incident, estimate losses and gather evidence that will stand up in court. ■

Market approach: Is it right for your business?

The market approach is often used to value private businesses. It derives value from pricing multiples based on comparable (or "guideline") businesses or ownership interests that have been sold. However, this approach is sometimes overlooked because it can be hard to find comparable businesses. Here's an overview of two methods under this approach and various criteria that business valuation experts may use to identify comparables.

Private transactions

The first method under the market approach is the guideline merger and acquisition (M&A) method. Here, pricing multiples — such as price-to-pretax earnings or price-to-revenue — are derived from proprietary databases that catalog private sales transactions. Unlike public companies, private businesses aren't required to disclose the details of their equity transactions to the general public, but

they (or their business brokers) might voluntarily give (or sell) the information to a proprietary transaction database.

The guideline M&A method may seem straightforward, but there are potential pitfalls to avoid. For example, transaction databases provide limited information about private deals and the companies' financial performance. Moreover, the information isn't verified and may contain errors. In addition, experts need to understand how each database defines terms, such as "earnings," "sellers' discretionary cash flow," and "sales price."

Publicly traded stocks

The second method under the market approach is the guideline public company method. It's based on free information from the New York Stock Exchange and other public stock markets. This audited financial data is prepared in accordance with U.S. Generally Accepted Accounting Principles (GAAP) and scrutinized by stock market analysts and the Securities and Exchange Commission.

The downside to using public stocks to value private businesses is that it's often hard to find pure players in a similar line of business. Most public companies are diversified conglomerates that participate in multiple industries. Moreover, private businesses typically have less sophisticated management teams and limited access to capital than public companies. So, this method is usually reserved for larger private companies — and, even then, the pricing multiples may need to be adjusted for differences in size and risk.

Selection criteria

Industry classification code is the most obvious way to filter public or private transaction data to find a relevant sample of comparables. But it's sometimes necessary to consider other criteria, such as:

- Product and service offerings,
- Company size,
- Transaction date,
- Profitability, growth and other performance metrics,
- Diversification,
- Geographic location, and
- Market share.

For example, when E. & J. Gallo Winery was valued in *Estate of Gallo*, the IRS determined that Hallmark Greeting Cards was a meaningful comparable, even though the companies operated in different industries. The common denominator, in the court's opinion, was similarities between the companies' market share — both were market leaders with well-recognized brands.

There aren't any guidelines on how big a sample of comparables needs to be. But a small, strongly correlated sample is generally preferred to a larger sample with only a loose correlation between the companies' financial metrics and selling price. Experts typically calculate the standard deviation or correlation coefficient to demonstrate that a sample is statistically relevant.

A viable method

The market approach isn't appropriate for every business valuation. But it's always worth considering — even as a sanity check for your expert's conclusion. Discuss the pros and cons of this approach with your valuation expert to determine whether it's relevant in your case. ■

Court clarifies damages for ESOP fiduciary breach

A business owner may have the best of intentions when setting up an employee stock ownership plan (ESOP). But if the ESOP is induced by the owner or other fiduciaries to overpay for the company's stock, a court can order those fiduciaries to pay damages. A key question in these cases is how to quantify them.

Alleging breach of fiduciary duties

The issue of quantifying damages arose in a recent case where a CEO sold his 52% share of the company to an ESOP for $406 per share in December 2010. Before the sale, the ESOP already owned 48% of the company. An annual appraisal conducted in 2009 determined that the fair market value for shares of the company was only $285 — a difference of nearly 30% from the price the ESOP paid.

The U.S. Department of Labor (DOL) sued the CEO and the transaction trustee that represented the ESOP and acted as its fiduciary. The DOL claimed they'd violated the Employee Retirement Income Security Act by approving the ESOP's purchase of the shares at an inflated price. Specifically, the DOL alleged that the trustee had violated its duties of prudence and loyalty. The DOL also argued that the CEO was jointly liable for the ESOP's losses as a knowing participant in a prohibited transaction and as co-fiduciary to the ESOP.

Calculating damages

At trial, the DOL's expert found the ESOP had overpaid by $11.5 million. The defendant's expert estimated an overpayment of about $5.5 million. Which expert was correct?

The court outlined two "viable methods" for calculating damages in the case:

1. Using a critique by the defendant's expert of the opposing expert's calculation, the court could calculate a discrete damages amount for each alleged error in the annual appraisal of company stock and adjust the calculation accordingly.
2. The court could credit the DOL expert's correction of the annual appraisal.

After the court's adjustments, the first approach estimated about $7.8 million in damages. The second approach, after adjustments, resulted in roughly $6.5 million in damages. The court found that both methods were imperfect, yet reasonable, methods for calculating damages. Ultimately, it opted for the second approach.

Building your case

Though the trial court in *Pizzella* wholeheartedly accepted the plaintiff's liability arguments, it made some adjustments to the DOL's position on damages. This ruling clearly demonstrates the importance of retaining qualified experts who can build a solid foundation for damages calculations. ■

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Nesser Consulting Group is an experienced team of consultants led by J. Michael Nesser, who was formerly associated with the Dispute Analysis and Corporate Recovery Practice of Price Waterhouse, LLP. Mr. Nesser has more than twenty-five years of experience in accounting and law.

Mr. Nesser is a CPA/attorney who is a professor of accounting and finance, a Certified Fraud Examiner, and Accredited by the American Institute of Certified Public Accountants in Business Valuation. We provide high quality consulting services at rates significantly lower than those charged by national accounting firms.

Our consultants have provided a wide range of consulting and expert witness services to attorneys and businesses throughout the country. Mr. Nesser has extensive experience in the areas of civil and criminal litigation, bankruptcy, domestic relations disputes and general business consulting.

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- Financial projections and computer modeling

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- Buy-Sell Agreements
- Gift and estate taxes

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- Insurance recoveries
- Fraud investigations
- Financial and economic analyses
- Quantification of damages

Domestic Relations
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- Tracing separate property
- Analysis of tax considerations
- Evaluation of property settlements
- Business valuations

Bankruptcy/Turnaround Services
- Assist in development of and/or analysis of Disclosure Statement and Plan of Reorganization
- Cash flow and sensitivity analysis
- Preference and fraudulent conveyance analysis
- Develop operating reports

OUR ROLE IN THE LITIGATION PROCESS

Preliminary Fact Finding and Discovery
- Identify relevant documents
- Identify financial issues in dispute
- Analyze disputed facts and financial issues
- Review and interpret findings

Pre-Trial Assistance
- Analyze accounting and financial data to determine economic and business aspects of the case
- Assist in the preparation and evaluation of arguments and counter-arguments
- Assist in preparation for depositions and interrogatories
- Assist in preparation or analysis of pleadings
- Assist in development of trial exhibits

Settlement Negotiations
- Assist in evaluating client's case and possible alternative courses of action
- Assist in development of negotiation strategies
- Evaluate proposals and their potential financial effects

Trial Support/Expert Testimony
- Provide professional and credible expert witness testimony on accounting, finance and economic matters
- Support cross-examination, including critique of the opposing party's financial evidence

TO LEARN HOW OUR LITIGATION SUPPORT TEAM CAN ASSIST YOU,
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