

# valuation outlook

BUSINESS VALUATION, FORENSIC ACCOUNTING AND LITIGATION NEWS OF SUBSTANCE

## Advising Small Business Clients When Fraud is Suspected

By: Gregory F. Lawson, CPA/ABV and Patrice Schiano, CPA

According to the 2004 Report to the Nation on Occupational Fraud and Abuse (Wells Report), prepared by the Association of Certified Fraud Examiners, small businesses are the most vulnerable to occupational fraud and abuse and suffer disproportionately larger losses as a result.

Study results indicate that the smallest organizations, 100 employees or less, suffered higher median losses than did all but the largest organizations of 10,000 employees or more. The study finds that small businesses suffer disproportionately large losses due to fraud; the median loss being \$98,000 among organizations studied. In addition, small businesses are less likely to have the ability to survive such losses.

As trusted business advisors, CPAs are often the first to be contacted when a client suspects fraud has occurred. This is particularly true for CPAs serving small nonpublic clients that may not have internal audit or human resource departments which are more familiar with the processes and procedures to be followed in such circumstances. How should you advise a client to proceed when fraud is suspected?

First and foremost, the client should be cautioned against reaching any conclusions until the alleged incident is investigated thoroughly. Listed below is a step-by-step process to follow in responding to suspected fraud. Steps one and two can be accomplished concurrently.

### Step One: *Determine the initial facts and circumstances*

- How did the client become aware of the suspected fraud?
- Are the allegations credible?
- Identify possible indicators of fraud.
- Are others aware of the suspected fraud?
- Could others be involved?
- Are there changes in the suspected employee's lifestyle?
- Were background checks performed?
- Theorize how fraud could have occurred.
- Estimate potential losses.
- Identify potential witnesses.
- Can someone substitute for the person suspected temporarily?

### Step Two: *Seek the advice of legal counsel to avoid potential litigation*

- Is the suspected employee an employee at will or is there a valid employee agreement?
- Are policies and procedures in place to deal with termination?
- Can the employee be placed on administrative leave?
- Are there policies and procedures regarding the expectation of privacy?
- Is fidelity bond coverage applicable in this situation?
- What procedures should be followed in investigating the allegations?

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# For the First Time, Tax Court Accepts Buy-Sell Agreement For Gift/Estate Valuation

*Estate of Pearl I. Amlie, 2006 Tax Ct. Memo LEXIS 76 (April 17, 2006)*

Sometimes the squeaky wheel does get more out of the will. Rod Amlie was one of several prospective heirs to his mother's assets, which consisted primarily of a 13.6% common stock interest in a bank. In 1986, his mother had struck Rod from her will—but established a spend-thrift trust for him. A couple of years later, she voluntarily accepted a court-appointed conservator, who spent the next decade attempting to secure a guaranteed buy-sell option for Mrs. Amlie's minority stake in the bank, his efforts largely thwarted by Rod's legal objections.

## Key factor is hiring valuator

Concerned that such a substantial portion of the Amlie assets were tied up in a minority interest, the conservator negotiated a 1991 agreement that fixed a price and buyer for the stock as well as a guarantee that her minority shares would receive the same price as those of the controlling interest, in the event the majority stakeholder sold.

In 1994, the majority owner (David Hill) sold his interest to First American Bank Group, Ltd. (FABG), receiving shares in FABG as determined by certain book value ratios of the merged banks. Per the 1991 guarantee, the conservator negotiated an exchange of Amlie's interest for FABG common stock at the same ratios received by Mr. Hill, which turned out to be close to \$118 per share; and—in a move that turned out to be critical later on—retained a valuation consultant to determine whether this was a fair price for the FABG stock together with the price guarantee, or what became known as the "Hill Rights."

To reach this opinion, the valuation specialist reviewed merger multiples for appropriate M&A comparables in the banking industry, and concluded that Mrs. Amlie's minority interest, coupled with the Hill Rights as well as the right to defer capital gains taxes until after death, was fairly priced at \$118 per share. The conservator submitted this 1994 agreement for court approval, contending that it established a further hedge against the risks of Mrs. Amlie's post-merger, minority interests.

Rod Amlie was the sole heir who objected, claiming that the \$118 price failed to compensate for the Hill Rights by up to \$500,000, as determined by his valuation expert. For various reasons, the district court rejected the 1994 agreement, which sent the parties back to negotiating a fair price for the FABG stock.

## The squeaky wheel could have been right

The family negotiations culminated in a 1995 agreement whereby all of Mrs. Amlie's bank stock would be sold to Rod's trust at the \$118 price. The trust could then pursue whatever price it could obtain, while the remaining heirs would have received a fixed price without incurring the risks of continued litigation and lack of liquidity.

Within two years, the trust had negotiated with FABG to redeem all of the stock at \$217.50 per share plus 4% per year compounded semiannually until Mrs. Amlie's death, thus securing a premium for the Hill Rights. When she died a year later, her bank interests sold at the negotiated price, and Rod (as executor) received \$993,757 for the estate's share at the \$118 price, plus an additional \$495,968, which then passed to his trust at the premium value.

## Estate valuation turns on "arms length" aspect

On its tax returns, the estate valued the minority bank interests at \$993,757; while on its fiduciary income tax return, Rod's trust reported the \$495,968 as capital gains. Not surprisingly, the IRS assessed a deficiency of \$495,968 against the estate's return, claiming that the value of the bank stock should equal the price that FABG paid for it following Mrs. Amlie's death. The estate claimed that the buy-sell agreement fixing the price at \$118 should be controlling.

To prevail, the estate would have to show that the buy-sell agreement was binding on all parties during life and after death; the restrictions had a bona fide business purpose, and were not substitutes for a testamentary disposition. In addition, the Tax Court said that under Section 2703(b)(3), a 1990 amendment to the Code, the agreement must be comparable to similar "arms length" arrangements.

Until this case, no court had found a buy-sell agreement to comply with §2703(b)(3). But in reviewing each of the requirements, the Court found:

1. *Fixed price.* The 1995 agreement fixed the \$118 price as a ceiling (and floor) on the value of Mrs. Amlie's FABG stock, thereby passing all the risk of subsequent loss (or gain) to Rod's trust; it was irrelevant that the precise portions of the trust's bequest wouldn't be known until after Mrs. Amlie died and the rest of her estate valued.
2. *Bona fide business purpose.* "We are persuaded that the conservator, in securing the [buy-sell agreement], was seeking to exercise prudent management of decedent's assets by mitigating the very salient risks of holding a minority interest in a closely held bank, consistent with the conservator's fiduciary obligations."
3. *Not a testamentary device.* This finding turned on the fairness of the consideration received, which was "significant," given the risks of "substantial litigation hazards." Notably, the conservator had only agreed to the \$118 price "after receiving professional advice that it was a fair price."
4. *Comparable arms-length terms.* Here, too, the estate's employment of a valuation specialist to establish market comparable prices for the buy-sell agreement was persuasive. Additionally, while §2703 favors multiple comparables for this purpose, the regulations "delineate more of a safe harbor than an absolute requirement."

The fact that Rod Amlie later secured a \$217 price per share "raises questions" whether the \$118 was comparable to similar, arms-length arrangements. But in the end, the agreement by his siblings to a lower price simply convinced the Court that the parties disagreed over the potential risks and rewards:

In the circumstances, the other prospective heirs struck a bargain for the proverbial 'bird in the hand' of a guaranteed price, transferring to Rod the benefits and burdens of the pursuit of the possible 'two in the bush.' It may have been a bad bargain in hindsight, but we are persuaded it was arm's-length when made. □

## Can a Divorce Client Sue Her Lawyer for Failing to Obtain a Business Valuation?

**Caudill v. Roberts, 2006 Neb. App. LEXIS 97 (June 13, 2006)**

The divorcing Caudills owned a substantial marital estate, valued by their accountant at over \$10.55 million, not including an additional \$2 million in antiques and collectibles (which they divided by agreement). Prior to trial, they also agreed to divide the estate equitably, allocating various limited partnerships to the husband and deducting \$412,000 in related tax liabilities from his share, so that he ended up with a net \$5.272 million and the wife \$5.275 million. (They were unable to resolve minor property/tax issues, alimony, and attorneys' fees, which did go to trial.)

### No independent appraisal of the L.P.s

During their marriage, the Caudills had acquired the limited partnership interests to shelter the husband's substantial income as a cardiologist. During their divorce negotiations, the family accountant had created a "Schedule of Potential Liabilities," which included the \$412,000 as potential income tax owed for the limited partnerships. The accountant had prepared the schedule for both parties, and the wife's attorney received it two weeks before trial. The schedule also included this critical note: "No estimated value, if any, is available for these partnerships." The parties used the schedule as the basis for their settlement—in effect assigning a negative \$412,000 value to the L.P.s without obtaining an independent appraisal.

After the divorce was final, the wife sued her attorney for malpractice, alleging that he'd failed to investigate the value of the L.P.s and advise her accordingly; and that as a result she'd received a lower share of the marital estate. Prior to the malpractice trial, the wife asked the court to find as "a matter of law" that the limited partnerships' value should not have been reduced by their hypothetical tax liabilities. The court agreed, adding that, per state law, the L.P.s should have been valued more as a business than an IRA or comparable asset; a court should not consider their tax consequences unless a sale is imminent.

At the close of evidence, the wife moved for a directed verdict, arguing that her attorney had—as a matter of law—failed to abide by the state practice standards. In other words, because she'd won summary judgment on the taxation issue, she should win on liability. The court disagreed, permitting the jury to return a verdict of "not guilty" for the attorney.

### A matter of fact—on which good experts may disagree

On review, the Appeals Court found that the attorney's liability did not flow from the summary judgment order but from the facts of the case. The summary judgment order was a correct statement of the law, while liability was a correct question of fact for the jury.

And in reviewing the facts regarding the limited partnerships' value, the Court found a predictable divergence of expert opinions. One of the wife's experts testified that her attorney never should have "allowed" a negative value for the L.P.s; or he should have verified that the \$412,000 tax liability was accurate. He did concede that the partnerships might have disadvantaged the wife financially, and that she had not wanted them. A second expert claimed that the accountant used the wrong tax rates for the L.P.s, due to the real property they owned in different states; moreover, as no one could determine their value with any certainty, they should have received a zero value instead of a negative \$412k.

The husband's experts agreed that the L.P.s were "unique" and impossible to value because they weren't assets; they were created exclusively as tax shelters; there was no market for them, and they were risky. The \$412k tax liability was the "only quantifiable way to value" them; and the only options were for the wife to agree with this value, letting the husband take them, or take an "in kind" portion with all associated risks. Further, if the parties had gone to trial on this issue (as they had on others), then the wife would have received the L.P.s, based on her position that they had zero value and the husband's that they were worth -\$412,000.

And if the wife had taken this position, the husband's attorney testified that he would have advised his client to litigate the issue, as the L.P.s were "minefields," "disasters," and "problems waiting to happen." The husband's CPA expert testified that two of the L.P.s were in the "taxable income phase" of their lives, four others were about to reach that phase—and two were on the brink of bankruptcy. There was "no means of valuation which would have provided a sound value for the limited partnerships," he said, "because cash flow is totally at the discretion of the general partners and the limited partnerships are unpredictable and uncontrollable."

### A valuation in time...

Finally, the wife's attorney testified that he knew the L.P.s were risky, and that he suggested at one point that the parties split them 50/50—but that the wife said she did not want the risks—neither the ones associated with taking the L.P.s or receiving them at trial.

On the basis of this record, the Appeals Court easily found factual evidence upon which the jury could have exonerated the wife's attorney. But the Court also noted his testimony, that "he knew the limited partnerships were involved in real estate," and that he'd discussed with the wife doing an appraisal—but that it would be "expensive" and "nothing [would] come out of it." There's no more perfect vision than hindsight, of course—but a timely appraisal by an independent or consulting expert might have saved these divorcing spouses quite a bit of cash and conflict. □

## In Discounts for Lack of Marketability, The Assumptions Are Everything

**Temple v. United States, 2006 U.S. Dist. LEXIS 16171 (March 10, 2006)**

After developing a \$2 billion timber company, Arthur Temple and his wife transferred over \$34 million in assets to their children and grandchildren, using four family-owned entities—three limited partnerships and an LLC. In valuing the gifts for his taxes, however, Temple did not consult an appraiser, and applied a 40% discount to two of

the entities. After an audit, the IRS declared that Temple had undervalued all gifts, and assessed an extra \$3.54 million in taxes and interest.

At this point, Temple hired a team of experts to challenge the deficiency. Their first step—arriving at a net asset value for each entity, went smoothly. But the second—determining the appropriate discounts, put the experts at odds with the IRS.

1. *Ladera Land, Ltd.* For this entity, which owned a ranch, Temple's expert combined a 25% minority discount. But the underlying data involved sales from publicly-held companies, and also used the inverse of a control premium study. Temple's expert also applied a 45% discount for lack of marketability, based on assumptions of a 10- to 15-year holding period and a 3% expected appreciation. But the expert had failed to discuss her assumptions with anyone at the company, and the company had no holding period requirement. These assumptions were "enough...to concern the Court with the reliability of [the expert's] calculations."

On the other side, the government's expert had examined average discounts for limited partnerships holding primarily real estate. This analysis "allows for numerous data points and assists the Court in arriving at a reasonable discount," which was a 33% combined discount for lack of control and marketability, plus an additional 7.5% incremental lack of marketability discount for a total discount of 38%.

2. *Boggy Slough West, LLC.* For this company, Temple had transferred a 76.6% non-management interest to one child, and several 1.6% interests to grandchildren. To value these gifts, his expert applied the same discounts, 25% lack of control and 45% DLOM. A second Temple expert took a sales comparison approach, considering the "numerous problems" associated with "absolute lack of control any individual [interest] has with respect to the property" and its dissolution. The Court agreed, concluding that a 60% discount was appropriate for the majority (76.6%) interest.

Surprisingly, the minority interests warranted a lower rate; the Court applied the same 38% combined lack of control/marketability discount to these as it had the Ladera gifts.

3. *Temple Interests, L.P. and Temple Partnerships, L.P.* For these identical investment holding companies, both parties' experts used closed-end funds to determine the minority discount, and restricted stock studies to determine the DLOM. (The Court rejected a third Temple expert who calculated a DLOM that depended on a 50-year holding period.)

Once again the Court favored the more comprehensive efforts by the IRS expert, who had not excluded any funds from his minority discount analysis, as Temple's expert had. The IRS valuator had also used the average discount of closed-end funds as opposed to Temple's expert, who "simply chose the discount" from the 75th percentile without providing sufficient explanation or support, according to the Court, which applied minority discounts in a range of 3.3% to 10.1%.

As for the DLOM, the IRS expert had not only looked to the restricted stock studies but also to: academic research; costs of going public; secondary market transactions; asset liquidity; partnership interest transferability; and historic distributions. This "fuller" analysis persuaded the Court to adopt his 12.5% lack of marketability discount.

#### A substantial gift back to the taxpayer

After applying the Court's discounts—including the substantial discount for a majority, non-management interest—the taxpayer did receive a \$7 million refund of taxes and interest, proving that his army of experts paid off, but perhaps begging the question of the time and money that could have been saved by filing the original return with a well-documented and well-developed appraisal. □

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## What to Do When the IRS Questions Your Estate Tax Discount

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The IRS has recently confirmed that discounts lead the list of "red flags" among filings for both estate tax returns (form 706) and gift taxes (form 709), which are first consolidated at the Cincinnati Service Center. Given the sheer volume of estate and gift tax returns, IRS agents rely on templates and models to sort out any problem returns. If the taxpayer has applied an unusually high discount, then the agents will turn to the supporting documentation—which had better be strong.

#### Take the proactive approach

But instead of waiting for auditors to start asking questions, taxpayers might try a more proactive approach by including valuation appraisals with any 706 or 709 returns. The reason: If the Service's estate and gift tax attorneys and examiners can answer all of their questions from the supporting valuation, then the return stays at the Cincinnati Service Center, and no further questions are asked.

Similarly, the tax-affected value of an S-corporation can still set off IRS warning signals, despite (or maybe because of) the U.S. Tax Court decisions in *Gross* and its progeny.<sup>1</sup>

At this point—if the IRS issues a challenge, you'll want to make sure to get your valuator involved, along with one of the IRS's ASA-credentialed experts. Increasingly, the IRS has been hiring in-house appraisers with valuation credentials from the American Society of Appraisers (ASA), the National Association of Certified Business Analysts (NACVA), the Institute of Business Appraisers (IBA), and others. Although there's no official count of how many valuation professionals are currently on the official IRS roster, there are now four Engineering Territory Managers

who oversee thirty-one engineering teams nationwide, and these names and numbers could prove indispensable in any dispute:

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It's a far cry from saying you've now got a friend at the IRS—but there are now more business valuation professionals at the IRS who understand the thorniest issues; and who have the same professional standards as your appraiser. If you can get one of them in the room during an audit, you've got a much better chance of finding someone who can at least understand your side, if not work with your appraiser toward a mutually agreeable solution.

1. *Gross v. Commissioner*, T.C. Memo. 1999-254, aff'd. 272 F.3d 333 (6th Cir. 2001). See also, *Heck v. Commissioner*, T.C. Memo. 2002-34 (2002); and *Adams v. Commissioner*, T.C. Memo. 2002-80, (2002) □

## Advising Small Business Clients When Fraud is Suspected

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### Step Three: Investigate the allegations

- Under counsel's direction, perform office searches and review email correspondence.
- Interview employees and others who may have knowledge of the suspected fraud. Interviews should be conducted by at least two people.
- Hire a private investigator and forensic accounting expert, if necessary.
- Make copies of, but do not work from or alter, original documents. These may be considered evidence and required in subsequent prosecution/litigation.
- Quantify losses.
- Consider contacting law enforcement.

### Step Four: Take precautions

- Consider placing the employee on administrative leave or terminate their employment.
- Deny access to the physical premises and associated properties.
- Secure company credit cards and safety deposit boxes.
- Disable computer and network accesses.
- Change signatories on all bank accounts.

### Step Five: Mitigate the damages

- Seek restitution.
- File a fidelity bond claim.

### Step Six: Advise the client on instituting internal controls

- Develop written accounting policies and procedures.
- Segregate functions and duties.
- Limit access to documents, computers and assets to only those who need access to perform their duties.
- Review and approve all journal entries and disbursements.
- Require dual signatures on all checks.
- Pre-number invoices and checks for ease of tracking.
- Conduct surprise internal control reviews.

- Ensure that key financial personnel take a vacation annually. Verify or audit their work during their absence.
- Secure fidelity bond coverage.
- Consider employing a third-party hotline service to receive tips of suspected fraud.
- Institute appropriate pre-employment screening processes.

Considering the devastating potential for loss from fraud by small business owners, CPAs need to be well informed to advise small business owners regarding incidents of suspected fraud. Equally important, they should advise small business owners about the need to make fraud prevention a top priority.

**About the Article:** An excerpted version of the preceding article was originally published in the American Institute of Certified Public Accountants, *Journal of Accountancy*, September 2006. The article above is presented in its entirety.

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