Firm Values

A Business Appraisal Publication

Fall 2016 Newsletter

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Presented By:

GRW APPRAISAL SERVICES

BUSINESS APPRAISAL AND LITIGATION SUPPORT SERVICES

I offer this newsletter to provide insight into current information and trends in business and the appraisal industry. I hope you find it enriching and welcome any questions or comments you may have. If there is a topic you'd like me to discuss or report upon let me know.


Greg Weichbrodt - Principal

We provide services including business valuation, litigation support, forensic accounting, transaction due diligence, operations consulting, and more. For further information about our practice please visit our website at GRWAppraisalServices.com or call us at 512-574-3444. Enjoy!

This writing presents summaries of emerging tax positions taken by federal and state governing bodies, recent court rulings on various issues, and the need for a thorough discovery process in divorce proceedings.

Proposed IRC Section 2704 Regulations May Drastically Reduce Estate Value Discounts

The Internal Revenue Service has argued that valuation discounts applied in the transfer of family limited partnership (FLP) and of other family-controlled holding entity ownership interests are utilized solely to avoid intergenerational wealth transfer, gift, estate, and generation-skipping transfer taxes. The Internal Revenue Service's goal is to eliminate intrafamily transfer valuation adjustments, which may represent a 25 to 45 percent discount from the net asset value of the effective underlying assets transferred.

The proposed regulations address the treatment of some lapsing rights and restrictions on liquidation in determining the value of certain transferred interests. Liquidation restrictions would be disregarded for valuation purposes resulting in the elimination of market-supported value discounts such as those for lack of control or lack of marketability.

Internal Revenue Code Section 2704(b)(1) of the proposed regulations provides generally that, if a transferor transfers an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family, and the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity, any "applicable restriction" [on transfer] is disregarded in valuing the transferred interest.

The proposed regulations may have a far ranging effect on the taxable value of interests in family-controlled holding entities. They appear to depart from the underlying Fair Market Value standard of value in order to generally impose higher taxes on family-controlled holding entities instead of specifically focusing on regulating those that are acting only to avoid the payment of taxes.

An expanded article on the subject can be found at Insights Journal.

Reasonable Compensation Questioned at Nonprofits

Hospitals operating as nonprofits in New Jersey are under attack. The level of executive compensation in the state's nonprofit hospitals is of primary importance in prosecution brought against the institutions. At risk is the nonprofit status and specifically, the state property tax exemption that is enjoyed by such nonprofits.

The outcome of the suit against Morristown Medical Center (MMC), the bellwether case decided in 2014, spurred a host of similar suits. According to NorthJersey.com, the level of executive compensation in 26 of 62 of the state's nonprofit hospitals is under scrutiny. In the MMC case, the loss of their property tax exemption amounts to additional state taxes of $2.5 million per year. Not only nonprofits are at risk in New Jersey - Princeton University has found itself in court over the same issue.

Our summer 2015 edition of Firm Values, we noted that in October 2014, the Internal Revenue Service issued a publication entitled: Reasonable Compensation - Job Aid for IRS Valuation Professionals. The publication identifies a long list of criteria on which companies can base an assessment of compensation reasonableness. For nonprofits both within and outside of New Jersey, it may be a good time to take a look at critical factors involved in how your state or even the court may look at determining reasonable compensation. Developing a defense for such an attack may prove timely.

U.S. Tax Court Update of Recent Cases Involving Valuation

The Consultants' Training institute published an article that highlights notable recent U.S. Tax Court Cases of interest to valuation practitioners and business advisors. *Estate of Barbara Purdue v. Commissioner, T.C. Memo, 2015-249* reminds us that taxpayers need to address Internal Revenue Code Section 2036(a) concerns. In order for an entity not to be disregarded for tax purposes a non-tax related business reason for entity existence and operation is required. In addition, the case reminds us that gifting an equity interest may not qualify as a present interest for gift tax purposes.

Estate of Newberger v. Commissioner, T.C. Memo 2016-246 involves the proper valuation of artwork, yet its holding is applicable to a business valuation opinion in that actual transactions in the subject interest, even those subsequent to the valuation date may prove most relevant in court.

Sumner Redstone v. Commissioner, T.C. Memo 2015-237 involves family succession planning and highlights the importance of filing a gift tax return in order to start the clock on the three year statute of limitations. Otherwise it remains open indefinitely. The 2015 case involves a 1972 transfer of shares to a trust for the benefit of his children. Additionally, and again in its determination of share price, the court relied upon a price from a prior transaction of shares in the subject company stock and disregarded the other income and market comparison based methodologies applied by the experts.

DNA Pro Ventures, Inc. Employee Stock Ownership Plan, T.C. Memo 2015-195 serves to stress the importance of following plan language and obtaining qualified appraisals in connection with an employee stock ownership plan (ESOP). The Tax Court upheld the IRS's disqualification of an ESOP, finding that the plan's allocation of stock to a corporate officer's account exceeded the contribution limits under IRC Code Section 401(a)(16) because the officer didn't receive any compensation from the corporation that year. In addition, the Court determined that the ESOP failed to obtain qualified appraisals of its assets. IRC Section 401(a)28(C) states that all valuations of employer securities which are not readily tradable on an established securities market with respect to activities carried on the the plan are by an independent appraiser.

Finally, *Kardash v. Commissioner, T.C. Memo, 2015-51* involves an unusual Rule 161 motion where the U.S. Tax Court addresses insolvency and fraudulent transfers. Appraisal experts for both the petitioner and the respondent were used to established dates of insolvency in order to determine whether certain transfers to minority shareholders were fraudulent. Ultimately, the Court ruled that since the subject transfers were within the determined insolvency period and were not an exchange for a reasonably equivalent value (of work effort) they were fraudulent.

Discovery in a Divorce Proceeding

Attaining adequate business records within a marital dissolution action can be a difficult or worse, impossible task. For many dependent spouses it is an uphill battle to force their spouse to divulge much-needed information. Yet full financial disclosure is critical for an informed settlement in equitable distribution proceedings. When one spouse is denied adequate discovery, his or her ability to determine the value of marital assets or level of community cash flow is jeopardized. Oftentimes, some records are available either because the spouse had previous access or there was a partial document production. Failing to obtain sufficient, reliable business records can ultimately result in the production of a report that is unknowingly incorrect and/or rejected by the courts. At times, the ability for an expert to render an opinion may not be possible.

Sometimes the records provided by the custodial spouse indicate the manipulation of transactions leading to situations where one spouse's expert reports substantially different income to the court than that determined by the other spouse's financial expert. Examples of such manipulation include unreported business revenues, understatement of accounts receivable, under reporting of inventory, and improper recording of owner's compensation (including perquisites) or other expenses, dividends, and loans. Such situations may not be identified by looking solely at summary financial data. Gaining access to supporting data such as an electronic copy of a company's accounting software can help to uncover the true nature of its financial position. Doing so will help lead to an equitable distribution of assets and determination of spousal support.

Discovery is intended to carry out an equitable distribution of marital assets. However, the court has discretion in determining allowable discovery and the reliability or admissibility of expert conclusions. The Federal Rule of Evidence 702: Testimony by Experts states:

> "If scientific, technical, or other specialized knowledge assist the trier of fact in issue, a witness qualified as an expert by knowledge, skill, experience, training or education, may testify thereto in the form of an opinion or otherwise if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case."

In *Daubert v. Merrell Dow Pharmaceuticals, Inc., 509 U.S. 579, 589 (1993)*, "the trial judge's responsibility with regard to expert opinions is to ensure that any and all scientific testimony or evidence admitted [at trial] is not only relevant, but reliable." Accordingly, a court can reject a business appraiser's findings if it is based on incomplete or erroneous data. There are many published cases where the testimonies of financial experts have been excluded due to inadequate or erroneously reported factual data.

My take away is that not only are summary level financial statements necessary to produce an expert opinion, but discovery to obtain documents containing supporting financial detail may prove necessary to produce a valid conclusion. The message from the courts is clear. One must use all appropriate means to obtain the evidence needed to render a reliable conclusion.

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