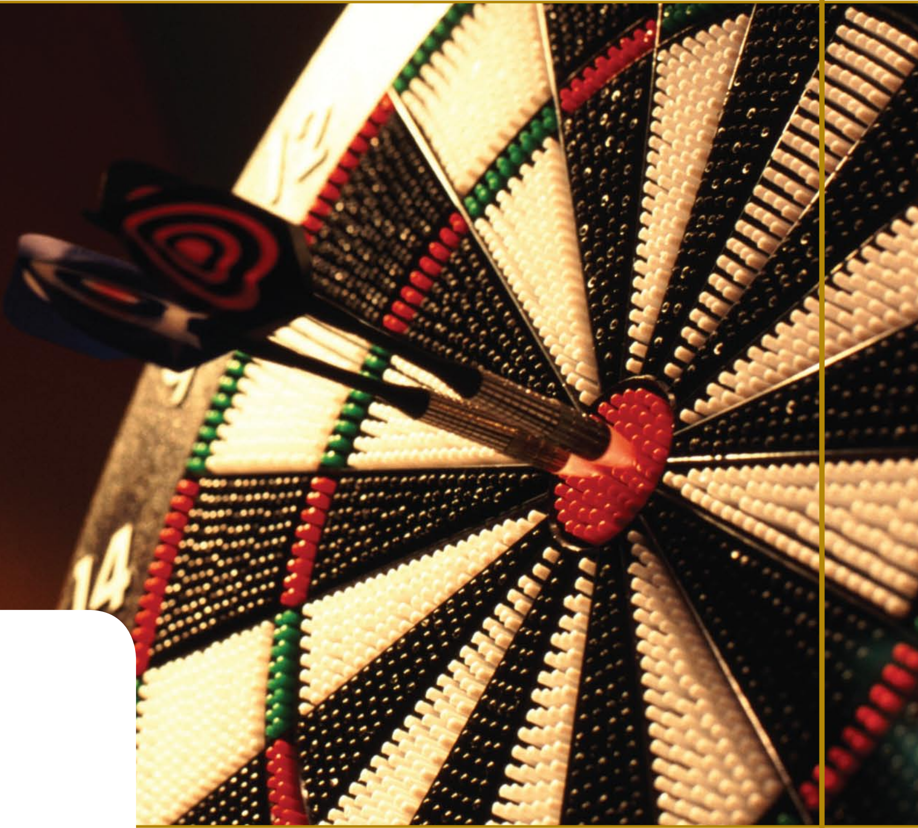
Advocate's EDGE



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Personal vs. enterprise goodwill
Another state recognizes the critical difference

Selecting guideline companies in a volatile market

What makes a fraud interview effective?

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Court's FLP ruling is a win-win — and a reminder

The number of cases challenging the legitimacy of family limited partnerships (FLPs) continues to grow. Typically, these can be classified as either a taxpayer or an IRS win, but one recent U.S. Tax Court case, *Estate of Miller v. Commissioner*, can be characterized as at least a partial victory for both sides.

FAMILY HISTORY

Valeria Miller's husband devoted 26 years of his life to researching and investing in securities using a specific methodology. When he died in early 2000, his gross estate was worth $7.67 million — 99.6% in the form of securities held by his revocable trust. In October 2000, the remaining assets in the trust were distributed to Miller's revocable trust.

In November 2001, a certificate of limited partnership was filed for the Miller FLP. Miller owned 92% of the units in the FLP as limited partner, and her four children owned the remaining 8%. No assets were actually contributed until April 2002, when Miller transferred 77% of her assets, retaining enough to pay her daily living expenses. Miller's oldest son knew his father's investment methodology, and Miller asked him to use it to manage the family's assets, which he subsequently spent approximately 40 hours a week doing.

On April 25, 2003, Miller broke her hip, and shortly thereafter received a pacemaker and underwent surgery. Her health continued to decline, and she died on May 18, 2003. Three days before her death, her oldest son had transferred most of the assets remaining in her revocable trust to the FLP.

The IRS argued that the FLP's trades weren't sufficient to qualify it as a legitimate operation.

CHALLENGING THE TRANSFERS

Under Internal Revenue Code Section 2036(a)(1), property transferred by a decedent during his or her life is nonetheless included in the gross estate at fair market value if the decedent retained "the possession or enjoyment of, or the right to the income from, the property," except in case of a bona fide sale for an adequate and full consideration. Miller's estate claimed that the April 2002 and May 2003 asset transfers constituted such bona fide sales. Therefore, they were eligible for a 35% discount when valuing Miller's interests in the FLP.

The court evaluated the validity of the transfers separately, and allowed the discount for the 2002 transfer. It found that Miller had legitimate and substantial nontax business reasons — to ensure that her assets continued to be managed according to her husband's method — for forming the FLP and contributing securities to it. The court also noted the son's active management of them.

The IRS argued that the FLP's trades weren't sufficient to qualify the FLP as a legitimate operation. But the court explained that an FLP's activities need not rise to the level of a "business" under the federal income tax laws for the bona fide sale exception to apply.

On the other hand, the court found that the 2003 transfers didn't have legitimate and substantial nontax business reasons. Rather, the decline in Miller's health and the desire to reduce her taxable estate were clearly the driving forces behind the transfers, so they weren't eligible for the discount.

REFRESHER COURSE

Although *Miller* is somewhat unusual for favoring the taxpayer in one instance and the IRS in another, it reaffirms lessons learned from previous FLP-related decisions: Well-planned and effectively executed asset transfers to FLPs can qualify as bona fide sales eligible for significant discounts. Hasty deathbed transfers, on the other hand, are less likely to hold up to scrutiny.

THE QTIP TRUST ISSUE

Valeria Miller in *Estate of Miller v. Commissioner* also was the beneficiary of a qualified terminable interest property (QTIP) trust funded on her husband's death. Under this type of trust, the surviving spouse receives income from the trust assets for life, and the principal goes to someone else at the survivor's death. Transfers to a QTIP trust qualify for the marital deduction when computing the tax on the estate of the nonsurviving spouse, but the QTIP trust assets are includible in the survivor's gross estate.

Miller's estate tax return, however, didn't include the QTIP trust's assets in her gross estate. The estate claimed she never had an interest in the trust because she never needed the income or received distributions.

But the court found that the surviving spouse's need is irrelevant. The proper questions are whether Miller was entitled to all of the income, payable at least annually, and whether any person had power to appoint any part of the property to any other person. Because those requirements were met, the fair market value of the assets must be included in Miller's gross estate.

Personal vs. enterprise goodwill

Another state recognizes the critical difference

The Kentucky Supreme Court recently joined the majority of states that distinguish between personal and enterprise goodwill when valuing a business. Such a distinction can significantly affect divorce settlements when one spouse holds an interest in a closely held business or sole proprietorship — particularly a professional practice.

STEPS TO THE STATE SUPREME COURT

The wife in *Gaskill v. Robbins* ran a successful oral surgery practice; her husband held several salaried positions with businesses throughout the marriage.

The marital estate was valued at more than $4 million, and the practice represented the biggest asset at issue in the case. The wife was highly skilled and earned about 90% of the couple's income during the marriage. The court characterized her as extremely hard-working and noted that she managed the practice frugally. She was the only oral surgeon, solely responsible for patient acquisition and primarily responsible for managing the office.

At trial, the wife's expert valued the practice at $221,610, with a value of zero assigned to goodwill

because her role amounted to a "non-marketable controlling interest." As the expert put it, "Why would a purchaser pay more than fair market value of the tangibles if Dr. Gaskill can take her patients, go down the hall, and set up a practice?" The husband's expert proposed a value of $669,075, including goodwill.

The trial court found the husband's view more credible and fixed the value of the practice at $669,075, primarily relying on the lack of legal authority for distinguishing between personal and enterprise goodwill in Kentucky. The court of appeals reversed that decision because it believed the trial court was under the mistaken impression that goodwill must be assigned a value greater than zero. The appellate court recognized that not all businesses have goodwill.

> *"Why would a purchaser pay more than fair market value if Dr. Gaskill can take her patients, go down the hall, and set up a practice?"*

PROBLEM WITH PERSONAL GOODWILL

As the Kentucky Supreme Court noted, although it was an issue of first impression for this court, valuing a business's goodwill has been a source of contention for many years. Since the mid-1980s, courts across the nation have considered the issue, leading to the concepts of personal and enterprise goodwill. Enterprise goodwill is associated with a business. Personal goodwill is the product of the practitioner's personal qualities, and it wouldn't continue to exist if that individual were no longer associated with the business.

The Kentucky court acknowledged that Dr. Gaskill's practice was marital property subject to division. But it questioned the feasibility of dividing a person's reputation, skills and relationships. The court cited with approval the decade-old Indiana Supreme Court opinion in *Yoon v. Yoon* which held that enterprise goodwill is divisible at divorce, but personal goodwill is a personal asset and not divisible.

Applying that reasoning, the Kentucky court found that the wife's personal goodwill couldn't be sold to a subsequent practitioner. Thus, it constitutes nonmarital property: "To consider this highly personal value as marital would effectively attach her future earnings, to which [her husband] has no claim. Further, if he or someone similarly situated were then awarded maintenance, this would amount to 'double dipping.'"

MAPPING THE DISTINCTION

The *Gaskill* ruling means that 30 states, as of this writing, have accepted the distinction between enterprise and personal goodwill. So, in these states, spouses will receive no share of their partner's personal goodwill.

Selecting guideline companies in a volatile market

When valuation professionals appraise a business using the market approach, they rely heavily on data from comparable or "guideline" companies. Selecting appropriate guideline companies is always important in preventing over- or undervaluation. But in times of economic uncertainty and extreme market volatility, selecting the right guideline companies is particularly critical.

BEING SELECTIVE

Valuators select guideline companies based on the type of business being appraised. Public companies are valued using market multiples from the stock prices of a handful of companies that are similar to the subject company in terms of industry, market and other characteristics. Closely held businesses are also sometimes appraised using the merger and acquisition (M&A) method, which derives pricing multiples from the sales of significant interests in comparable private businesses.

Although these methods can be effective in times of general economic stability, recent events call into question the reliability of guideline company data. When valuing smaller private companies (such as those with $10 million or less in annual revenues), the effectiveness of guideline companies may vary according to whether the valuator is following the M&A or public company method (using smaller public companies as guidelines).

PUBLIC VS. M&A

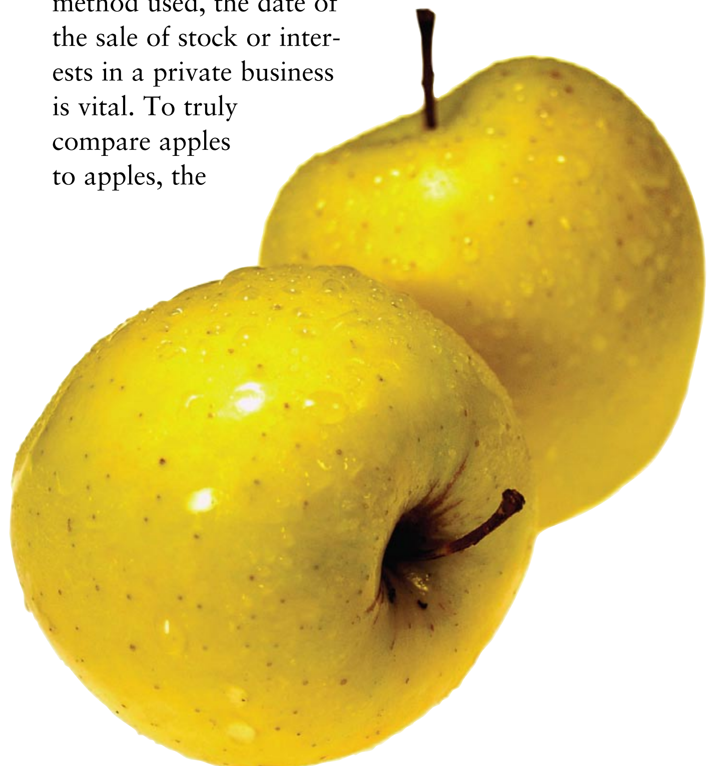
The public company method bases its multiplier on data such as price-earnings (P/E) ratios. But in a depressed stock market, the P/E ratios for many public companies are likely to be at historically low levels. The valuator then must make adjustments to the multiplier.

Such an adjustment may not be necessary using guideline companies under the M&A method, because it considers the prices for sales of significant interests in private companies, rather than shares of stocks. Buyers of publicly traded stock often take a relatively short-term view of their investments, but investors in private companies are usually owner-operators with a long-term perspective. So even though the number of private company sales has fallen in the last few years — and less comparable sales transaction data is available — the multipliers for many small companies have remained stable.

IN THE DETAILS

The details of transactions used as guidelines are critical, though. Acquisitions made despite economic woes may have been made by buyers who attempted to minimize their risk by using an earnout as a larger percentage of the total deal price. In these cases, the reported prices don't reflect the earnout, so a multiplier that relies on a reported price may be artificially low.

Regardless of the guideline method used, the date of the sale of stock or interests in a private business is vital. To truly compare apples to apples, the



stock purchases or sales transactions must have occurred when the economic conditions and M&A activity were similar to those at the valuation date.

DOUBLE-CHECKED RESULTS

Experienced valuators typically apply several valuation methods when appraising a business. Assuming guideline company data is solid, the results they get using the asset and income methods shouldn't deviate much from the market method's results. But if there's a significant disparity, the guideline companies will be scrutinized to determine if the timing, location or some other characteristic of the companies was off-base.

What makes a fraud interview effective?

Even companies with ethical business cultures and tight internal controls can fall victim to occupational fraud. The key to catching and punishing fraud perpetrators is to gather evidence quickly and — even more important — professionally. As you know, this means that owners and managers who suspect an employee shouldn't try to conduct fraud interviews on their own.

Conducting effective fraud interviews requires knowledge about everything from behavioral psychology to criminal law to accounting and auditing rules. That's why engaging a forensic expert to perform this critical task could mean the difference between recovery of stolen funds and a successful prosecution, and the perpetrator getting away with thousands — even millions — of dollars.

STEP BY STEP

When they interview fraud suspects, forensic experts aim to find the stolen funds and determine whether they can be returned to the company. These experts also can uncover key evidence to help in a criminal prosecution or a civil suit leading to a judgment against the suspect's assets. Finally, they'll try to obtain a signed confession, though this, of course, is easier said than done.

To gain the best chance of securing a confession, the expert first needs documentary evidence the suspect committed the fraud. So he or she starts by examining company books and records, as well as insurance claim reports, management reports and, if available, police reports. The expert also gets acquainted with the suspect's responsibilities, authority in the company and work history.

Before questioning the primary suspect, the expert interviews other employees who may know of the scheme. Even those least likely to be involved can sometimes provide useful information. Next come people who may be helping the perpetrator, and, finally, the actual suspect.

IN THE HOT SEAT

Suspects don't have to agree to be interviewed, but refusal raises a big red flag, so most employees will consent. A forensic expert knows how to create a "comfort zone" for the suspect so he or she feels at ease going into the interview and is less likely to clam up while it's in progress.

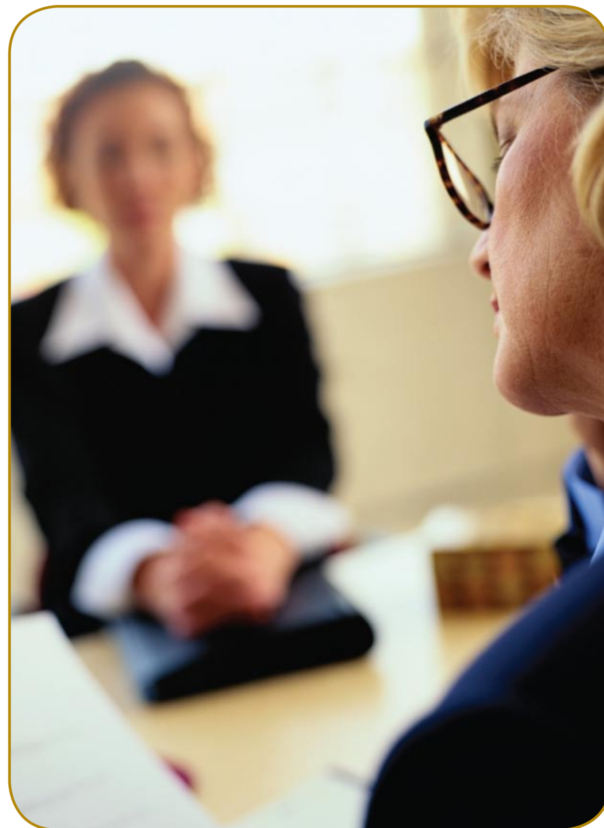
Often forensic experts write down key points to guide the talks, rather than writing actual questions that can inhibit spontaneity. And they generally start interviews in a casual, conversational mode, avoiding questions that may seem intimidating or pointed. Because body language is as important as spoken answers, forensic experts carefully watch their subject's facial expressions and postures.

Before questioning the primary suspect, the expert interviews other employees who may know of the scheme.

Forensic experts don't talk too much but truthfully answer the suspect's questions about why he or she is being interviewed — for example, "We're auditing the company's financial statements and would like your help." And experts avoid acting defensive even when subjects become aggressive or threatening.

WRAPPING UP

When a fraud suspect understands the documentary evidence against him or her and seems ready to confess but is still stalling, some forensic experts will suggest a motive other than greed. "Family financial problems" often works well. Indeed, a



"nobler" motive lets the perpetrator confess and still save face.

Once a subject confesses, the forensic expert tries to pin down the total amount stolen, in case some evidence has yet to surface. Numbers the suspect initially provides can be significantly understated, so persistence is essential. This is also the time to ascertain exactly where the stolen money is and whether the company can get it back.

Finally, experts try not to leave the interview without a written statement. This may be the only time the perpetrator is willing to put it all in writing and affix a signature. The expert then signs as a witness.

KNOWLEDGEABLE AND DETACHED

Few company owners or managers have the knowledge and skills to successfully conduct a fraud interview. But forensic accountants are experts in the matter. They have another advantage as well: no personal relationship with the suspect, which means they're unlikely to let their feelings get in the way of hard evidence.

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