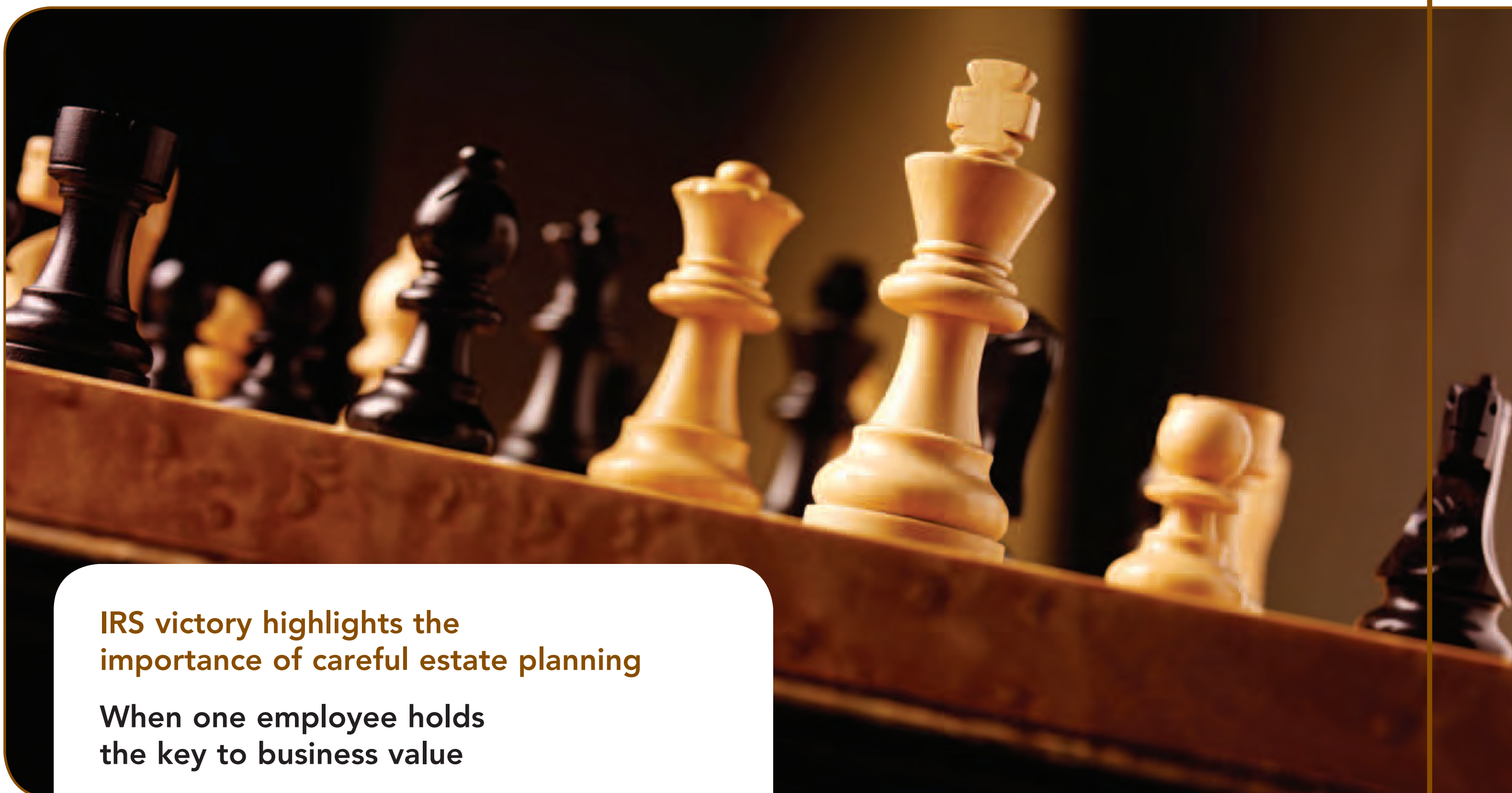
Advocate's EDGE



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McGOVERN & GREENE LLP

CPAs & Forensic Accountants

IRS victory highlights the importance of careful estate planning

Recently, the IRS celebrated another victory in its long-running campaign to challenge family limited partnerships (FLPs). In *Estate of Lockett v. Commissioner*, the agency attacked an FLP for being an invalid partnership under state law. Ultimately, however, it was the decedent's estate planning that undermined the FLP, thus handing the IRS another win.

WIDOW TAKES OWNERSHIP

Lois Lockett was predeceased by her husband, whose will established a trust for her benefit (Trust A). In 2000, as part of her estate planning, Lockett formed Mariposa Monarch, LLP under Arizona law. The partnership's formal agreement, signed in 2002, named her sons Joseph and Robert as general partners. Lockett, the sons and Trust A were named as limited partners. At that point the parties hadn't yet agreed on initial capital contributions or their percentage interests in Mariposa.

Shortly after the agreement was signed, Lockett and Trust A began funding Mariposa. Joseph and Robert never made any contributions. In 2003, Trust A was terminated, and Lockett became the owner of her limited partnership interest in the partnership. An amended agreement was executed to reflect this. The agreement continued to list the sons as Mariposa's general partners, but an exhibit listed their mother as holding 100% of the partnership and each of the sons holding 0%.

When Lois Lockett died in 2004, Mariposa held assets worth more than $1 million. On its tax return, the estate valued Lockett's 100% ownership interest in Mariposa at $667,000 after applying control and marketability discounts.

IRS RAISES STATE LAW

Initially, the IRS argued that Mariposa wasn't a valid partnership under Arizona law. In that state, partnerships are defined as an association of two or more persons and are formed to operate a business for profit. The IRS contended that only Lockett contributed assets to Mariposa and that Mariposa wasn't operated for profit.

COURT ALLOWS LOANS TO STAND

The Tax Court in *Estate of Lockett v. Commissioner* (see main article) also considered the issue of whether some cash transfers that the FLP made to Lois Lockett's sons were loans or gifts for federal gift tax purposes.

The IRS asserted that, although the transfers were loans in form, they were gifts in substance. The estate countered that they were loans in form *and* substance because the FLP entered into a bona fide creditor-debtor relationship with the sons at the time of the transfers. Although transfers between family members are presumed to be gifts, the presumption can be rebutted by evidence that, at the time of the transfer, the transferor had a real expectation of repayment and an intention to enforce the debt.

The court, siding with the estate, found that the FLP treated certain transactions as loans. The FLP's accountant drafted promissory notes, kept amortization schedules and reported each transaction as a loan. Further, the transactions were listed as FLP assets on the federal estate tax return.

Nevertheless, the court found that Mariposa *was* a valid partnership. Although the sons didn't hold interests in it, Trust A contributed assets and was therefore a limited partner, satisfying the requirement of an association of two or more persons.

The court also found no requirement that an Arizona business engage in a certain level of economic activity. Moreover, it determined that Mariposa *was* operated to derive a profit. The partnership hired a financial advisor to manage its stock portfolio, purchased real estate that it leased and made loans requiring annual interest payments. It thus operated as a business for profit.

TRUST TERMINATION FOUND FAULTY

Unfortunately for the estate, the IRS had an alternative argument. Even though a valid partnership was formed, it had terminated at the time of Lockett's death because she had acquired 100% of the interest in it. This occurred when Trust A was terminated in May 2003 (effective Dec. 31, 2002).

The court found that Mariposa was a valid partnership. Although the sons didn't hold interests in it, Trust A contributed assets and was therefore a limited partner.

At that point, Lockett had become the owner of Trust A's limited partnership interest in Mariposa as well as being its sole partner.

Arizona law provides that a partnership is dissolved when a dissolution event previously agreed upon in the partnership agreement occurs. The Mariposa agreement established that the FLP would be dissolved when one partner acquired all of the other partners' interests. So on Dec. 31, 2002, Mariposa dissolved and Lockett became the legal owner of its assets.

MANY POTENTIAL ERRORS

Because the FLP had dissolved by the time of Lockett's death, its assets were included in her gross taxable estate. If her sons had made contributions to fund their general partnership interests or she had gifted them with small interests in Mariposa, the FLP may well have withstood scrutiny and removed the assets from the estate.

Lockett's mistakes were only a few of the many errors that can sabotage an FLP. To protect your clients from IRS attack, work with financial experts when drafting partnership agreements and making estate plans.

When one employee holds the key to business value

A company's earnings and cash flows can suffer significantly when an executive or other critical employee leaves. Small and service-oriented businesses and professional practices are particularly vulnerable to such financial losses.

To account for this risk, professional valuators may apply a key-person discount. These discounts don't apply to all business appraisals and they're rarely one-size-fits-all. Thus, a valuator must ask several questions specific to the subject company and its key employees.

WHICH APPRAISALS ARE AFFECTED?

Choosing when a key-person discount is appropriate can be tricky. Smaller closely held businesses are likely to depend on one or more critical employees, but such risk is often accounted for in a separate "size premium." Larger closely held companies or public companies usually are able to replace key management personnel and thus minimize potential losses.

In general, businesses that sell products are better able to withstand the loss of a key person than service businesses, which depend to a greater extent on key employees' knowledge, reputation and relationships. However, a product-based company that relies heavily on technology or intellectual property may be at risk if a key person possesses specialized technical knowledge.

WHO ARE THE KEY PEOPLE?

Key people provide value in different ways, depending on the roles they play in their companies. For example, a key person might:

- Drive the company's strategic vision,
- Handle day-to-day management responsibilities,
- Offer technical expertise,
- Lend his or her excellent reputation, or
- Provide access to an extensive network of contacts.

Personal relationships are a critical factor in identifying key employees. If clients, customers and vendors deal primarily with one person, they may decide to do business with another company if that person is gone. On the other hand, it's easier for a company to retain customer relationships when they're spread among several people within the company.

A key person may also have a financial impact on the business. It's not unusual for the CEO or another executive in a closely held business to personally guarantee the company's debts. Lenders may call in such debts if the key person is no longer with the company.

HOW DEEP IS THE BENCH?

When determining key-person discounts, valuators must assess the ability of others to fill key employees' shoes. To survive without a key person, existing management must have the knowledge, skills and business acumen to continue normal operations without interruption.

Another key factor is whether there exists a comprehensive succession plan that formally outlines which individuals assume control after key people leave. In the absence of a plan, the departure of one key person could trigger power struggles or require the company to bring in a replacement who isn't familiar with the organization.

WHAT'S THE IMPACT?

Identifying risks associated with key persons is one thing; estimating the impact of those risks on business value is quite another. Valuators generally use one of three methods to incorporate key-person discounts into their calculations: 1) Adjust future earnings to reflect the risk of losing a key person (typically used when a key person's departure is imminent), 2) adjust the discount or capitalization rate, or 3) discount calculated value by a certain percentage (similar to a marketability or minority interest discount).

Quantifying the discount can be challenging because little empirical support for across-the-board key-person discounts exists. However, research has shown that, in cases where a discount was appropriate and a departure was reasonably certain, the applicable decrease in value associated with a key person's loss ranged between 4% and 6%.

BEST OUTCOMES

Among the many legal contexts in which key-person discounts can arise are marital dissolutions, shareholder disputes, mergers and acquisitions, and tax court challenges. To ensure the best outcome for your client, work with a valuator who has experience estimating such discounts and is capable of defending his or her appraisal methodology in court.

How accurate are corporate earnings reports?

Researchers from Duke University and Emory University recently released surprising results of their study on the prevalence of corporate earnings "management." As described in the report, "Earnings Quality: Evidence from the Field," the researchers surveyed 169 CFOs of public companies and conducted in-depth interviews of 12 CFOs and two setters of accounting standards. Their report provides valuable insight into earnings manipulations that potentially could affect damages calculations and other legal matters.

SIGNS OF QUALITY

The report explains what constitutes high-quality earnings. According to the surveyed CFOs, a company's earnings are "high quality" when they're sustainable and backed by actual cash flows. Other, more-specific characteristics of quality include consistent reporting choices over time and avoidance of long-term estimates.

The study's researchers indicate that this view of earnings quality is consistent with a valuation perspective because a company's value is assessed by estimating and discounting the stream of future profits. Thus, current earnings should be considered high quality if they serve as a reliable guide to a company's long-term profits.

WHAT'S WRONG WITH MANAGEMENT?

For its part, earnings management is defined as manipulation that misrepresents performance but nonetheless falls within Generally Accepted Accounting Principles (GAAP). The CFOs estimated that, in any given period, roughly 20% of companies manage earnings, and that the typical misrepresentation was about 10% of reported earnings per share.

> *Current earnings should be considered high quality if they serve as a reliable guide to a company's long-term profits.*

The study's subjects believe that 60% of earnings management increases income, while 40% decreases income. While the latter figure may sound counterintuitive, the researchers attribute it to accounting practices such as "cookie jar reserves," whereby, for example, a company records a discretionary expense in a period with high profits because it can afford to take the income hit.

"Big baths" is another accounting practice that could explain the 40% decrease. In that scenario, a company manipulates its income statement to make weak results appear even worse by, for example, shifting profits from a bad year forward to artificially enhance the following year's earnings. Such manipulation produces a performance bonus.

WATCH FOR RED FLAGS

Researchers asked the participants to list three red flags that would help detect earnings misrepresentations. The most commonly cited were:

1. Earnings inconsistent with cash flows. More than 100 CFOs identified this or the similar "weak cash flows" and "earnings strength with deteriorating cash flows" as warning signs. The authors noted that the importance of the link between earnings and underlying cash flows was prominent throughout the study.

2. Deviation from norms. Deviations from industry norms or experience registered 88 responses. Specific examples include disparity in financial statement items such as cash cycle, average profitability, revenue and investment growth, and asset impairments.

3. Unusual accruals. Another red flag is "lots of accruals or unusual behavior in accruals," including large jumps. The CFOs emphasized *changes* in accruals, as opposed to extreme levels of accruals.

LOOK OUT

With reported earnings playing a critical role in a variety of legal matters — from damages calculations to transaction prices — your clients can't afford to take them at face value. A qualified financial expert can help detect managed earnings that misrepresent performance.

Weight vs. admissibility

Court allows lost profits expert testimony

When an opposing party in a lawsuit challenges the admissibility of an expert's testimony, the matter often comes down to one of two interpretations: whether the court believes the party's arguments go to the *admissibility* of the evidence or to the *weight* of the evidence. The ruling in a federal district court case, *BK Cypress Log Homes v. Auto-Owners Insurance Co.*, illustrates such determinations and highlights the need to present relevant expert testimony.

2 CALCULATIONS

BK Cypress Log Homes sued Auto-Owners Insurance Company, alleging bad-faith conduct in the handling of a third-party claim. The defendant moved to exclude the plaintiff's damages expert's testimony on the grounds that his techniques weren't generally accepted in the economic community. The expert used a two-part model, estimating lost profits with both the before-and-after and yardstick methods.

In his first calculation, he determined the plaintiff's profit margins before and after the loss period. He attributed the difference to effects created by BK Cypress owner Jim Keeton's participation in dispute-related activities that should have been handled by the defendant and that resulted in operational inefficiencies.

In the second calculation, the expert considered what the plaintiff's sales would have been if the company had matched the industry average sales for the loss period. He used sales information from a log-home industry publication, as well as a "sample survey" of members of the Log Homes Council. Together, these sources yielded growth rate numbers for six companies.

COURT REJECTS CHALLENGE

In the Florida court, the defendant asserted that the plaintiff's before-and-after analysis wasn't acceptable because it assumed that all loss in profitability was attributable to the defendant's bad faith. In particular, Auto-Owners faulted the lack of data documenting:

1. The amount of time Keeton spent attending to dispute-related matters, and

2. The failure to account for time he would have expended on such matters even in the absence of bad faith.

The court concluded that the defendant's criticisms should be raised through cross-examination of the expert and other witnesses regarding the assumptions underlying the damages calculation.

The defendant also argued that the yardstick analysis wasn't acceptable because, among other things, the expert's report didn't establish that the businesses used to measure the losses were sufficiently similar to BK Cypress. The court denied the motion to exclude this part of the analysis — but without prejudice to the defendant's right to exclude the testimony at trial if the plaintiff was unable to establish the survey data's reliability through other evidence.

REBUTTABLE WITNESS ALSO REBUFFED

Notably, the court also rejected the testimony of the defendant's financial expert because he didn't provide an estimate of damages. It characterized that expert's testimony as a rebuttal opinion that failed to offer an alternative analysis methodology.

In the end, the court decided that the defendant's expert's testimony wouldn't aid the jury in determining damages and would in fact be "redundant and unduly prejudicial." Instead, the defendant was instructed to explore the criticisms in its expert's report during cross-examination of the plaintiff's expert and other witnesses.