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November/December 2012

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A buy-sell agreement goes to divorce court

Closely held businesses commonly rely on buy-sell agreements to facilitate liquidity and smooth ownership transitions. But the agreements also occasionally play a part in divorce proceedings. In one such case, *Wood v. Wood*, a Missouri appellate court rejected a buy-sell agreement's valuation formula as the basis for valuing the business in the divorce settlement.

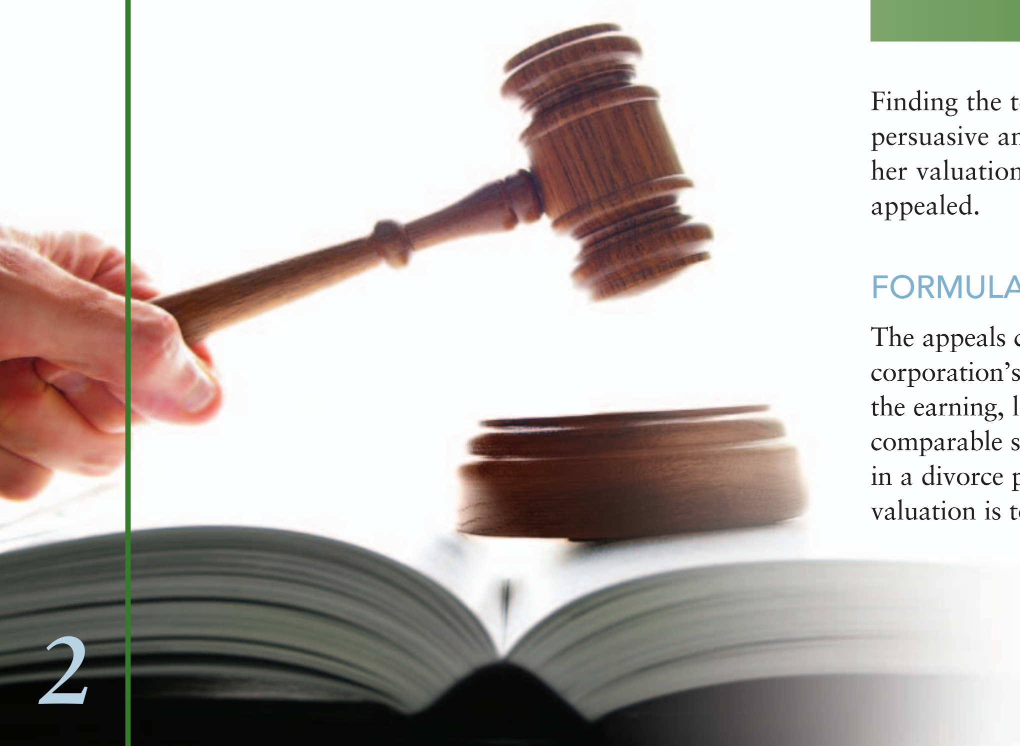
DUELING VALUES

The husband was an employee and part owner of a closely held corporation. At their divorce trial, he and his wife both presented expert testimony on the value of his interest in the business.

The wife's expert applied a valuation formula included in the buy-sell agreement that her husband and the two other shareholders entered into in 2007 when they purchased the business. The formula provided that the total shares' value equaled the last appraised value of the company, plus or minus earnings or losses, and less dividends paid or declared by its board. Using this approach, the expert calculated the total value of the business to be approximately $3.5 million, with the value of the husband's interest being about $1 million.

The husband's expert conducted an actual appraisal of the business and presented an opinion on the fair market value (FMV) of his interest. The expert relied on traditional measures of valuing closely held businesses, including accounting for goodwill, minority ownership and the impact of the economic recession. He calculated the FMV of the husband's interest to be $325,000.

The main lesson in Wood *is that it's critical to ensure that a valuation is seeking the appropriate standard of value for the matter at hand.*



Finding the testimony of the wife's expert more persuasive and credible, the trial court relied on her valuation formula's calculation. The husband appealed.

FORMULA FLAWS

The appeals court noted that a closely held corporation's share value is usually reached using the earning, liquidation (or underlying asset) or comparable sale approach. It also pointed out that, in a divorce proceeding, the objective of a business valuation is to determine FMV as of the date of trial.

WHY USE A BUY-SELL AGREEMENT?

Properly structured buy-sell agreements offer many benefits to the owners of closely held businesses. For example, such an agreement can:

- Limit ownership to family members or other specified individuals,
- Prevent stock transfers that could endanger the business's status as an S corporation,
- Provide liquidity for the family of a deceased shareholder,
- Create an exit strategy for current shareholders, and
- Preempt misunderstandings and disputes between shareholders.

The valuation of a business is vulnerable to disputes, whether between shareholders or other stakeholders such as spouses. Buy-sell agreements, therefore, must be clear about the standard of value to be applied (for example, fair market value or fair value) and whether value will be determined by a formula or an independent appraisal.

However, the wife's expert's calculation didn't seek FMV. Moreover, the expert didn't use a current appraisal of the business as part of the calculation of present share value. Instead, the expert used the historical value of the company in 2007 as the starting point.

The appellate court acknowledged that a trial court generally can accept the opinion of one expert on value over another and can prefer one valuation method over others based on the particular facts of the case. But it explained that, when an expert's testimony doesn't attempt to determine FMV, a trial court simply can't find it more persuasive and credible than another valuation. And it can't rely on such testimony in valuing the shares.

The trial court, therefore, had misapplied the law. The appeals court reversed and remanded for a proper determination of the value of the business as of the date of the divorce.

EASIER ISN'T BETTER

The main lesson in *Wood* is that it's critical to ensure that a valuation is seeking the appropriate standard of value for the matter at hand. But the case provides a secondary lesson as well: Although the valuation formula in the husband's buy-sell agreement didn't harm him here, it could in other situations.

Say, for example, the husband was involved in a dispute over how much he was required to pay a co-owner who was exiting the company. Using a formula like that in the *Wood* case, he could end up paying the co-owner about three times as much as he would if FMV were determined under traditional methods.

It may seem easier and cheaper to include a valuation formulation in a buy-sell agreement than to provide for an independent appraisal. But it's not advisable because formulas often are overly simplified. They may rely primarily on preset multiples of historical earnings or on current book value. Such formulas often exclude subjective, but important, factors such as the company's risk premium and future growth rate, current economic conditions, and other key factors that involve professional judgment and analysis. A full valuation by an independent appraiser can account for all critical elements.

DRAFTING A SOLID AGREEMENT

Depending on the jurisdiction, an enforceable buy-sell agreement should provide for an up-to-date appraisal. A valuation expert can work with you and your client to draft a solid agreement, as well as provide a current appraisal when needed, whether for purposes of divorce, ownership changes or other reasons.

Why now is prime time for a fraud sweep

Year end is an ideal time for businesses to tie off loose ends — and this includes assessing their fraud controls. A system that may have been effective five years ago when a restaurant chain had only one location or a company manufactured a single product may not meet the organization's changing needs or address the risks associated with expansion.

For many companies, business slows down around the holidays. Encourage your clients to take advantage of this downtime to conduct a year end fraud sweep with the help of a forensic accounting expert.

INVESTIGATION PREP

There are hundreds of ways to commit fraud, and the signs aren't always obvious. A thorough, objective review performed by an expert can unveil suspicious losses that may indicate fraud. It also can identify internal control weaknesses that may leave a business vulnerable to fraud perpetrators.

Among the documents a fraud expert will examine are:

- Bookkeeping records,
- Invoices,
- Bank statements,
- Payments,
- Journal entries, and
- Financial reports.

Management can assist by ensuring easy access to records and personnel. It should pay attention to how long it takes employees to produce documents. If some records are missing, management needs to ask why and what steps employees took to find them. Documents that can't be located are a red flag for fraud.

DOWN TO BUSINESS

Experts typically look for signs of doctored, forged or missing documents or anything that doesn't "feel right." For example, an unusual number of journal entries posted near the end of the fiscal year could be adjustments made to cover theft or misappropriation.

Adjustments to receivables and payables are possible signs that employees are misappropriating customer payments or engaging in billing schemes. Another red flag is out-of-balance books. An end-of-year inventory of merchandise or cash can bring missing assets to light.

Experts pay particular attention to payroll documents. Missing or otherwise unaccounted-for employees could indicate the presence of "ghost" employees. Management can help to expose such schemes — in which perpetrators pay nonexistent staff members — by personally handing out year end paychecks or bonuses (or paper stubs if employees have their checks direct deposited). Any leftover checks merit further investigation.

Management should also observe employee behavior. Fraud perpetrators often avoid taking vacation or sick time for fear someone will uncover their activities in their absence. And thieves may seem irritable or defensive when asked to comply with an organized fraud sweep.

DEALING WITH SUSPICIONS

If something appears suspicious, businesses must be willing to confront it — and resist the temptation to explain away exceptions. Also, if an employee is caught, management shouldn't assume that this employee is the only culprit. Unfortunately, fraud schemes often involve more than one person.

And fraud can be committed by people outside the company or by a combination of employees and outsiders.

But warning signs don't always lead to a thief. Accounting irregularities may be explained by genuine errors or an ill-designed process. Honest mistakes can be corrected and avoided in the future with better training, process improvements or the addition of more-effective controls.

If a company hasn't already established a system for employees, vendors, customers and the public to report suspicious activities, it should do so. While not required of private companies as they are of public ones, confidential hotlines can cut fraud losses by approximately 50% per scheme, according to the Association of Certified Fraud Examiners.

CLEANING HOUSE

Year end fraud sweeps enable businesses to close the books on the old year and welcome the new one with confidence. Although management can provide valuable information and assistance, it should hire an experienced fraud expert to conduct the actual review.

Gift smart

Wandry offers guidance on defined-value clauses

The U.S. Tax Court recently provided valuable guidance on using defined-value clauses in gift documents — guidance that should have significant estate planning implications. In fact, the court's ruling in *Wandry v. Commissioner* can help taxpayers who want to transfer assets to family members before Jan. 1, 2013, when the lifetime gift tax exemption is scheduled to be reduced from $5.12 million to $1 million unless Congress acts.

ARRANGEMENT IS CHALLENGED

In 2004, a married couple executed gift documents that provided they were giving membership units in a family-owned limited liability company (LLC) to their children and grandchildren. The documents identified the gifts in specific dollar amounts, rather than in percentages. The documents included a defined-value clause stating that the number of units was based on their fair market value, "which cannot be known on the date of the gift but must be determined after such date." The clause also stated that, if it were ultimately determined (including by the IRS or a court) that the value of the gifted units differed from the dollar amounts specified, the units would be adjusted to gift the intended amounts. The couple's intent was to give units that were of dollar amounts equal to their available federal gift tax exemptions and annual exclusions.

On their 2004 gift tax returns, the couple reported the amount of the gifts detailed in the gift documents — $261,000 for each child and $11,000 for each grandchild. Their CPA relied on an independent appraisal of the LLC to conclude that each 1% interest was worth $109,000. He therefore described the gifts in the returns as gifts of 2.39% interests to the children and 0.101% to the grandchildren, rather than as dollar amounts.

Based on these percentages, the IRS valued the interests at $366,000 and $15,400, respectively, and challenged the gift tax returns. Among other things, it asserted that the defined-value clause didn't save the couple from taxes because it created a condition (a valuation) subsequent to completed gifts.

COURT UPHOLDS THE CLAUSE

The Tax Court considered the IRS's contention regarding the couple's defined-value clause. It described the issue as an old one "that has evolved through a series of cases where the Commissioner has challenged a taxpayer's attempt to use a formula to transfer assets with uncertain value at the time of the transfer."

The documents identified the gifts in specific dollar amounts, rather than in percentages.

Some federal courts have upheld formulas used to limit the value of a completed transfer. But the Tax Court has invalidated previous attempts to reverse completed gifts in excess of gift tax exemptions and exclusions. However, the Tax Court has drawn a distinction between a *savings* clause, which a taxpayer can't use to avoid gift tax, and a *formula* clause, which is valid. Savings clauses are void because the taxpayer essentially tries "to take property back." Formula clauses merely transfer a "fixed set of rights with uncertain value." The pivotal question is just what the donor is trying to gift.

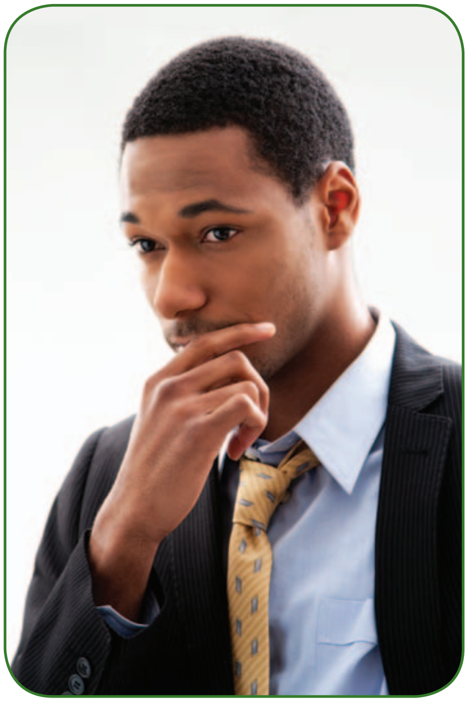
In this case, the court concluded that the couple's defined-value clause was a valid formula clause. On Jan. 1, 2004, each donee was entitled to a predefined LLC percentage interest expressed through a formula. The formula included an unknown — the value of the LLC as of Jan. 1, 2004 — but that value was constant. The gift documents didn't allow the Wandrys to take property back but merely corrected the allocation of the units.

ANOTHER TAKEAWAY

Notably, previous cases that upheld formula clauses generally involved clauses that reallocated interests among the donees, with any transfers in excess of the specified dollar amount going to a charity. According to the Tax Court, though, it's "inconsequential" that a clause doesn't reallocate the units to a charity if the reallocations don't alter the transfers.

Taxing breach of contract settlement proceeds

Attorneys need to understand how settlement proceeds are taxed, because taxability can have a significant impact on settlement negotiations. The IRS recently issued a legal memorandum that provides some guidance on the taxability of settlement proceeds resulting from a breach of contract.



DELIVERY CANCELED

The taxpayer in IRS Internal Legal Memorandum (ILM) 201203013 entered into a contract with a manufacturer to purchase a product. Pursuant to the contract, the taxpayer made nonrefundable deposits toward the final purchase price. When the manufacturer was unable to meet the delivery schedule, the taxpayer canceled the agreement. It subsequently contracted with another manufacturer to obtain the product at a higher price.

The taxpayer and the original manufacturer entered into a settlement agreement that paid the taxpayer financial compensation. This compensation was less than the amount the taxpayer paid the second manufacturer. The agreement also required the manufacturer to repay the deposits, plus interest.

TAXABILITY FACTORS

The taxpayer maintained that its capital was impaired to the extent of the excess of the purchase price from the second manufacturer over the original purchase price from the first manufacturer. Thus, it argued, all of the settlement payments were nontaxable because they contributed to restoring the taxpayer to its pre-breach position.

According to the IRS's memo, the taxability of proceeds from a lawsuit or settlement depends on the nature of the claim and the actual basis of the recovery. If the amount recovered is tied directly to, and replaces, destroyed or injured capital, it's a nontaxable return of capital — except when the amount recovered exceeds the tax basis of what was lost. In this case, the return of the deposits was return of capital — and therefore nontaxable. The interest, however, represented payment to the taxpayer for the use of the taxpayer's money and *was* taxable.

As for the financial compensation, the IRS explained that settlement proceeds aren't taxable if they do no more than restore the taxpayer to the position it was in before the loss. But if a contract breach causes a loss and the payment does more than restore the taxpayer to its pre-breach position, all or part of the recovery is taxable. Payments to compensate for lost income caused by the breach are also taxable.

Ultimately, ILM 201203013 took no position on whether the financial compensation described was taxable. It left the question to the Large Business and International Division of the IRS.

OPEN QUESTION

The settlement agreement described didn't stipulate the grounds or purpose for the financial compensation. But the memo stressed that this fact alone shouldn't dictate whether the compensation is taxable consideration for lost profits.