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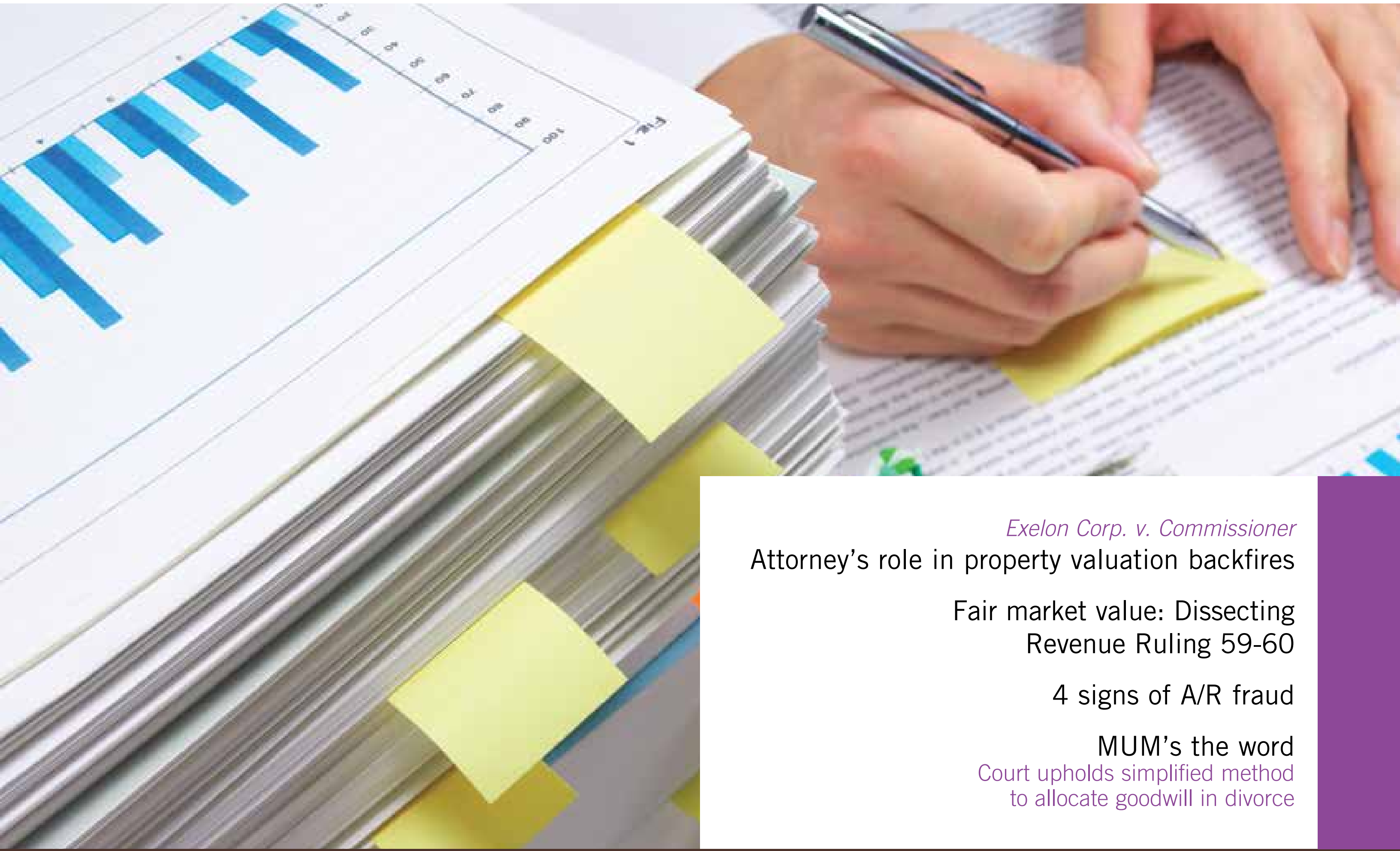
ADVOCATE'S EDGE



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Exelon Corp. v. Commissioner

Attorney's role in property valuation backfires

The key to a solid appraisal is the expert's independence. Though it can sometimes be tempting to try to influence an appraiser's conclusions, the potential consequences can be costly.

In a recent tax case, the Seventh Circuit Court of Appeals found that meddling by the taxpayer's legal counsel in the appraisal process rendered the reports "useless." Ultimately, his meddling undermined the taxpayer's reasonable cause defense to almost $90 million in underpayment penalties.

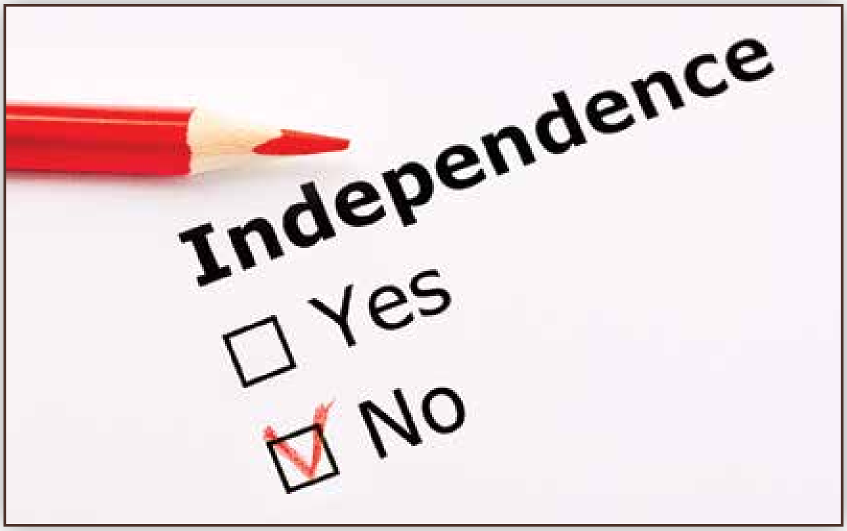
Background

In *Exelon*, the IRS challenged like-kind exchanges executed by an Illinois-based energy company. Taxpayers generally use such exchanges of "relinquished property" for "replacement property" to defer taxable gains.

In 1999, Exelon had sold some fossil-fuel power plants and reaped over $2 billion more than expected. Faced with a hefty tax bill due to the $1.2 billion gain it realized on the sales, the taxpayer entered several sale-and-leaseback transactions.

The taxpayer characterized these transactions as like-kind exchanges for tax purposes after its legal counsel issued tax opinions stating that the transactions qualified for such treatment. These opinions were largely based on appraisals of the replacement properties.

> The attorney interfered with the "integrity and the independence of the appraisal process" by providing a list of expected conclusions.



The appraiser was hired by the taxpayer's attorney, who provided a list of conclusions that were necessary to support Exelon's tax position. The attorney also gave continual, substantial feedback on draft appraisal reports. The final reports reproduced the attorney's list of conclusions almost verbatim.

The IRS disallowed the tax benefits the taxpayer claimed from the transactions and determined the company was liable for an income tax deficiency of about $437 million. It also imposed $87 million in accuracy-related penalties. The U.S. Tax Court affirmed, including the penalties, and the taxpayer appealed.

TCJA curbs like-kind exchanges

The Internal Revenue Code has long permitted taxpayers to use like-kind exchanges to defer taxable gains. But, when Congress drafted the Tax Cuts and Jobs Act (TCJA), the fate of Section 1031 exchanges was uncertain.

Though the final legislation didn't eliminate like-kind exchanges, it does *limit* them. Sec. 1031 tax treatment is no longer allowed for exchanges completed after 2018 of personal property used for business or investment purposes (such as equipment, airplanes, vehicles and patents).

Like-kind exchanges remain permissible for real estate held not primarily for sale — that is, real estate held for business or investment purposes. The limitation on Sec. 1031 exchanges is permanent — unlike many of the other changes under the TCJA.

Costly interference

Internal Revenue Code Section 6662 imposes a mandatory 20% penalty on the portion of any underpayment of tax that's attributable to negligence or disregard of rules or regulations. The term "negligence" includes any failure to make a reasonable attempt to comply with the tax code. According to the relevant tax regulations, negligence is "strongly indicated" when the taxpayer doesn't make a reasonable inquiry into the correctness of an item that appears "too good to be true."

The IRS contended that like-kind transactions producing hundreds of millions of dollars in tax savings qualified as "too good to be true." The Tax Court, however, sustained the penalty on the grounds of disregard of rules and regulations, as evidenced by the taxpayer's reliance on tax opinions that were flawed due to the attorney's interference with the underlying appraisal reports.

On appeal, the taxpayer argued that the reasonable cause defense to the penalties applied, because Exelon had reasonably and in good faith relied on the advice of its legal counsel. But, to relieve a taxpayer of penalties, the advice must not have been based on unreasonable factual or legal assumptions, including those the taxpayer knows or has reason to know are untrue.

The attorney's advice in *Exelon* was based largely on the appraisals. The Tax Court found — and the Court of Appeals agreed — that those appraisals were tainted, because the attorney had interfered with the "integrity and the independence of the appraisal process" by providing a list of expected conclusions. The taxpayer asserted that it had no way of knowing the appraisals were tainted.

However, the appellate court found extensive evidence that the taxpayer knew its attorney had influenced the appraiser's conclusions. For example, a mechanical engineer employed by the taxpayer sent the list of the necessary conclusions to the appraiser multiple times. And he and an employee in the taxpayer's tax department were copied on emails the attorney sent to the appraiser.

The courts also dismissed the taxpayer's argument that its attorney was merely providing the existing guidance and tests on the relevant issues. As the Tax Court noted, the appraiser was known for its experience and expertise in the appraisal field. And the attorney had no reason to think the appraiser was unaware of the guidance.

Better safe than sorry

As the Tax Court noted, "[A] wink-and-a-smile is no replacement for independence when it comes to professional tax opinions." It's helpful to provide appraisers with all necessary information. But final conclusions should be left to the appraiser's independent, professional expertise. ■

Fair market value: Dissecting Revenue Ruling 59-60

Did you know that a milestone piece of IRS guidance provides a step-by-step outline of the factors to consider when valuing a private business? Here's an overview of those factors, along with other hidden details found in IRS Revenue Ruling 59-60's fine print.

Customize the analysis

According to the Revenue Ruling, business valuation is an inexact science, often resulting in "wide differences of opinion" about the value of a particular business interest. Therefore, experts must take a customized approach that considers the following factors:

- Nature and history of the subject company,
- Outlook for the general economy and industry,
- Book value and financial condition (from at least two years of balance sheets),
- Earnings capacity (from at least five years of income statements),
- Dividend-paying capacity (as opposed to dividends actually paid),
- The value of goodwill and other intangible assets,
- Previous arm's-length transactions involving the subject company's stock and the size of the block of stock, and
- Market prices paid in comparable transactions.

When evaluating these factors, valuators try to gauge a company's risk and financial condition, as well as estimate its future performance. Historical levels of stability, profits, growth and diversity are relevant to a hypothetical investor only if this data can be used to develop the subject company's future performance trends.

Consider three approaches

After experts learn about business operations and market conditions, Revenue Ruling 59-60 instructs them to consider three approaches in every valuation assignment. First, the cost approach looks at the company's book value, its financial condition and the value of intangibles. Next, the income approach is based on earnings and dividend-paying capacity. Finally, the market approach reflects previous transactions involving the company's stock and market prices of comparable businesses. An expert may choose to apply one or more of these approaches when estimating business value.

Revenue Ruling 59-60 cautions against the blind use of averages when considering these approaches. Instead, it's better to pick the technique that provides the most meaningful result than to simply average all three together. Averaging the results "excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts of the case except by mere chance."

Review the fine print

In its discussion of these factors, Revenue Ruling 59-60 describes several other factors that may affect the value of a closely held business. For example, when a company relies heavily on key people, its value may be impaired if they leave. The depressing effect is especially pronounced if the company hasn't implemented a succession plan or required key people to sign noncompete agreements. Life insurance policies and competent management can offset these risks, however.

> Revenue Ruling 59-60 essentially instructs experts to consider three approaches in every valuation assignment.

Another consideration when valuing a business is nonoperating assets. Investments, real estate and other assets that aren't essential to a company's normal business operations may require a higher or lower rate of return. So, experts typically value them separately when appraising a business. They also adjust for income and expenses related to the nonoperating assets.

Likewise, adjustments may be required to the company's historical earnings for income and expense items that aren't expected to happen again in the future. Examples include revenues and expenses from discontinued product lines or a one-time windfall from an insurance claim.

Revenue Ruling 59-60 doesn't prescribe a universal capitalization rate for every company. Instead, rates of return on earnings must be determined based on the nature of the business, risk, and stability or irregularity of earnings. Riskier businesses generally require higher capitalization rates, which results in lower values (and vice versa).

Read the full text

Have you taken the time to read Revenue Ruling 59-60 in its entirety? It provides definitive guidance for business valuations prepared for tax purposes. But, over the last 60 years, it's been cited in valuations used for a wide variety of purposes. Contact your valuation professional with questions or to learn how it applies to a specific subject company. ■

4 signs of A/R fraud

Accounts receivable (A/R) represent amounts that customers owe for goods and services purchased on credit. Because of the high transaction volume, the A/R account is a popular fraud target.

How do these frauds work? Sometimes, a customer's payment is stolen by an employee. Outstanding receivables also may be exaggerated, say, by a salesperson who wants to boost commissions or by a CEO who's desperate to meet investors' expectations. Regardless of the ploy, A/R fraud can be costly, and early detection can help minimize losses. Here are four signs that something is amiss with receivables.

1. Slow turnover

A/R turnover measures how quickly invoices are converted to cash. It can be computed by dividing annual sales by receivables. A slowdown happens when a fraud scheme makes it appear that customers are paying later than usual.

For example, in January, Pat, the A/R clerk at XYZ Co., was unable to pay a large personal medical bill, so she "borrowed" a customer payment on Invoice A. Pat planned to repay the "loan" with her year-end bonus. In the meantime, she applied the payment on Invoice B to cover up her initial theft, then applied the payment on Invoice C to Invoice B, and so on.

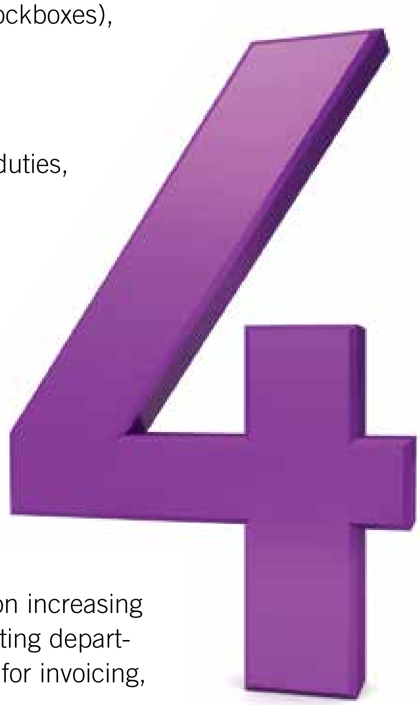
Internal controls are a company's first line of defense against employee fraud schemes.

Pat's so-called "lapping" scheme didn't end when she received her bonus, however. Pat received more medical bills and a hefty federal tax bill in April. So, she "borrowed" more from her employer, and the company's CFO began to wonder why the A/R balance seemed bloated — and why there was an increase in accounts over 60 days overdue.

2. Missing controls over financial reporting

Internal controls are a company's first line of defense against employee fraud schemes. In addition to physical controls (like locks, surveillance cameras and lockboxes), companies should require:

- Mandatory vacations,
- Segregation of financial duties,
- Year-end and surprise audits, and
- Management review of subordinates' work.



Continuing with the previous example, Pat was a long-term trusted employee, who *never* missed work. As the company grew, she had taken on increasing responsibility in the accounting department. She was responsible for invoicing, deposits, journal entries and bank reconciliations. Pat even managed billing complaints from customers.

Her scheme unraveled when health problems caused Pat to take medical leave in May. The CFO began to review her work and noticed numerous misapplied payments and discrepancies between the A/R schedule and the general ledger.

3. Excessive write-offs and errors

A fraudster can regain control over a lapping scheme by simply writing off the amounts that have been stolen — or burying them in a one-time adjusting journal entry. That's why it's important to review end-of-period adjustments, customer returns, and other credits to A/R and sales.

If bad debts are mounting, the change should jibe with external market conditions. For example, collection issues may arise during a recession, if a major customer is under financial distress or if salespeople are selling to high-risk customers.

4. Customer complaints

Tips from customers often help detect A/R fraud schemes. If customers consistently complain that payments have been misapplied, posted late — or not posted at all — it may be a red flag that their payments are being applied to the wrong invoice or account.

Sometimes, however, a dishonest employee knows someone who works for a customer, and they work together to misappropriate funds. Collusion makes it especially difficult to detect A/R fraud because the thieves work together to cover up the fraud trail.

To catch a thief

Experiencing one or more of these signs doesn't automatically prove that fraud is happening. But it may warrant further investigation. Contact a forensic accounting specialist for more information. ■

MUM's the word

Court upholds simplified method to allocate goodwill in divorce

When the marital estate in a divorce case includes a private business interest, a valuation expert may be needed to allocate value between personal and business goodwill. That's because more than half the states exclude the former from the marital estate, depending on state law, legal precedent and case facts.

To determine the proper allocation, courts increasingly are accepting a straightforward approach known as the multiattribute utility model (MUM). Here are the details, including a recent court decision that permitted its use.

How it works

The MUM is used to support decisions in a variety of disciplines, including economics, politics and science. It applies scientific methodology to an imprecise, subjective analysis.

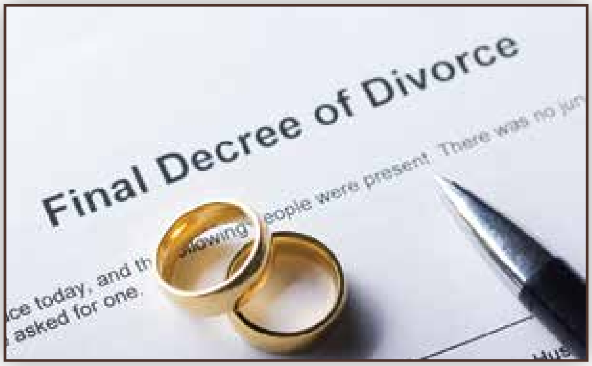
In the context of goodwill, an expert generally identifies several attributes that are indicative of either:

- Personal (or professional) goodwill, such as specialized knowledge, in-bound referrals and personal reputation, or
- Business (or enterprise) goodwill, such as location, systems and outbound referrals.

Then the expert assigns weights to each attribute, depending on existence (meaning the strength of the attribute's presence) and its importance (relative to other attributes). These weights are multiplied to produce a "multiplicative utility" factor for each attribute, and the factors are added together. The objective is to express personal and business goodwill as percentages of the total goodwill.

Case in point

The MUM was used in a recent Illinois Second District Court of Appeals case. In *In re Marriage of Preston*, the husband was the sole shareholder in a manufacturing company that had almost $3.1 million of goodwill.



His expert applied a MUM with 10 personal and business goodwill attributes. He assigned each attribute a value of either 1 if it had a "significant presence," or 0 if it was weak or not present.

Based on the score of 6 for personal goodwill and 3 for business goodwill, the expert attributed two-thirds of the total goodwill to personal goodwill. That's almost twice the amount the wife's expert allocated to personal goodwill. Her expert compared projected cash flows over five years if the husband were to leave the company with vs. without a noncompete agreement.

The trial court accepted the estimates made by the husband's expert. On appeal, the wife attacked the MUM as "far too subjective, and far too suspect" for the courts to accept. The appellate court recognized that the MUM includes some subjective components, but it pointed out that even the wife's expert acknowledged its acceptance in the business valuation industry.

Bringing science to subjectivity

The MUM introduces elements of consistency, order and objectivity when performing a subjective task, like the allocation of goodwill. That's why courts are increasingly embracing this concept in divorce cases that include a business interest. ■

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