

ADVOCATE'S **EDGE**



Help wanted: Qualified appraisers

Do you need a business valuation for year-end gifts of stock?

Hiring an expert to help prove —
or refute — accountant liability

FRE 702 amendment would
clarify expert testimony standard

Use a rebuttal expert to break valuation deadlock

990 Stewart Avenue
Garden City, New York 11530

☎ 516.288.7400

☎ 516.288.7410

✉ info@garibaldicpas.com



GARIBALDI
GROUP

Certified Public Accountants
Financial and Management Consultants

www.garibaldicpas.com

Help wanted: Qualified appraisers

Do you need a business valuation for year-end gifts of stock?

The combination of current tax laws and a rocky economy makes this an advantageous time for many business owners to gift shares of closely held stock to family members. Such gifts can produce significant benefits to both the givers and recipients, but a reliable business valuation from a qualified appraiser is essential.

Perks of stock gifts

High net worth taxpayers have multiple reasons to consider gifts of closely held stock. For example, gifting appreciated shares will allow the giver to avoid long-term capital gains taxes in the future and lock in the value of the gift before future appreciation occurs. If those shares weren't transferred until the giver's death, any appreciation would be included in the estate.

Such gifts can be particularly useful when given to family members in lower tax brackets than the giver. The recipients could sell some or all of the appreciated shares and pay no capital gains tax or at least a lower rate than the giver would (15% vs. 20%). Or they might hold on to the shares and enjoy the future income. Either way, the appreciation is removed from the giver's estate.

Generous (but temporary) tax rules

The current state of the federal tax law regarding gift and estate taxes should greatly incentivize the gifting of stocks for most taxpayers. The Tax Cuts and Jobs Act

(TCJA) almost doubled the federal gift and estate tax exemption. For 2022, the inflation-adjusted annual gift tax exemption is \$16,000 per recipient (\$32,000 for married couples) and the lifetime exemption is \$12.06 million (effectively \$24.12 million for married couples). Gifts that don't exceed the annual exemption don't count toward the lifetime exemption. (Note: Some states also charge inheritance or death taxes, and the exemptions may be much lower than the federal exemption.)

Absent congressional action, the high federal exemptions will sunset on December 31, 2025, and return to the pre-TCJA limit for 2026 and beyond. President Biden has even proposed returning the lifetime exemption to its inflation-adjusted Obama-era amount of \$3.5 million (\$7 million for married couples) before then. He also supports a top estate tax rate of 45%, up from the TCJA's 40%.

The IRS has confirmed that any gifts made under the TCJA's increased gift and estate tax exemptions



GRATs: An alternative to gifting

Some clients may prefer to employ a grantor retained annuity trust (GRAT) to gift closely held stock, as opposed to an outright gift. GRATs enable high net worth individuals to transfer appreciating assets to family members with few, if any, tax consequences.

A GRAT is an irrevocable trust funded by a one-time contribution of assets (for example, stock in a closely held company). The trust pays the grantor an annuity, at least annually, for a specific term. The aggregate value of the annuities typically equals the initial contribution. Income, gains and losses flow to the grantor, rather than the trust. When the term expires, the assets remaining in the trust transfer to designated beneficiaries.

Importantly, the grantor's gift tax is assessed based on the beneficiaries' remainder interest in the assets' *initial* value. That means appreciation can pass to beneficiaries free of gift and estate taxes. And the asset growth distributed to the beneficiaries is excluded from the grantor's estate.

won't be clawed back if the donor dies after the exemption falls to pre-TCJA levels in 2026. That makes this an opportune time to gift stock and other assets.

Timely opportunity

Stock gifts can be particularly appealing because, between economic uncertainties and the lingering effects of the COVID pandemic, many closely held businesses have experienced dramatic drops in revenue. They also may have been forced to take on more interest-bearing debt. Both factors reduce a company's value.

At the same time, the amount of valuation discounts for a lack of marketability and a lack of control in closely held businesses may have increased, depending on the company's circumstances (including its financial performance). The result is that taxpayers can gift more shares to family members — and remove future appreciation from their estates — without eating into their exemptions as much as they would if the shares were worth more.

It's worth noting, too, that various proposals have been floated over the years to limit the availability of valuation discounts for transfers of interests in family-owned businesses. If enacted, they could substantially undermine the tax benefits of certain intrafamily transfers.

Valuation matters

For estate and gift tax purposes, gifts of stock are valued on the date of the transfer. The fair market value of shares in publicly held companies can easily be discerned by checking the relevant stock index. But valuing stock in privately held companies calls for a formal appraisal.

For estate and gift tax purposes, gifts of stock are valued on the date of the transfer.

The IRS keeps a close eye out for intrafamily transfers that may undervalue stock by, for example, relying on book value. Such undervaluation can lead to penalties and interest, as well as additional taxes. The best way to withstand IRS scrutiny is to obtain an independent valuation by a credentialed expert who's familiar with the IRS's accepted methodologies.

Seize the day

Your clients may not be aware of how current forces are creating “the perfect storm” for giving stock in closely held companies to their family members. Let them know why they should act soon. ■

Hiring an expert to help prove — or refute — accountant liability

Many businesses have failed, and continue to fail, during the pandemic and the ensuing economic turmoil. In lawsuits involving business failures, it's common for shareholders and other plaintiffs to name the business's accountants or auditors as defendants. Accountants' liability depends on several factors, including the applicable state negligence statutes and professional standards. Here's an overview of those standards, along with the accountant's level of responsibility for the financial statements.

Key factors

There's a common misconception that, if fraud occurs or numbers in financial statements are inaccurate, the accountant or auditor must have done something wrong. In reality, it's far more complicated than that. An accountant's liability depends on such factors as:

- Which professional standards apply,
- Whether the accountant met those standards, and,
- Whether the accountant's transgression caused the plaintiff's damages.



An accountant's liability also may extend to third parties who relied on or benefited from the accountant's work product.

Relevant standards

The highest level of assurance comes from an audit, which provides an opinion on whether financial statements are fairly presented in accordance with U.S. Generally Accepted Accounting Principles (GAAP) and are free of material misstatements. The auditor conducts certain testing, inquiry and other procedures to assess the accuracy of information in the financial statements.

Some expert testimony challenges raise matters of weight, rather than admissibility.

Public companies are required to file annual audited financial statements with the Securities and Exchange Commission. Private companies also may need audited financial statements to satisfy lenders or other third parties. All auditors must follow U.S. Generally Accepted Auditing Standards (GAAS). In many cases, a review or compilation will suffice. A review determines whether financial statements are based on appropriate accounting principles, applied consistently.

Accountants performing a review attest that information in the financial statements appears to be reasonable and that they're unaware of any material departures from GAAP. This conclusion is based on interviews with management and a review of the business's financial statements, but it involves no testing or other audit procedures. In

a compilation, the accountant compiles data from the company's financial records and places it into a financial statement format, assisting the company in correcting any obvious errors or omissions.

Auditor's role

In cases involving accountant liability for business failures, the plaintiff must establish that the accountant failed to meet professional standards and that this failure caused harm from which the business couldn't recover. The defendant must overcome misconceptions about the auditor's role and help the trier of fact understand the accountant's level of responsibility for the financial statements.

For example, it's important to explain that GAAS doesn't require specific tests and procedures. Rather, it provides guidelines for designing an audit that, in the auditor's professional judgment, is appropriate based on the subject company's accounting system, internal controls and other characteristics.

Also, contrary to popular belief, auditors aren't guarantors of the accuracy of financial statements. Instead, a company's management initially

prepares the financial statements and has primary responsibility for their accuracy. And many financial statement entries require management to make estimates or exercise judgment.

Based on management's representations, together with limited testing and other audit procedures, the auditor must obtain *reasonable* assurance that the statements are free of material misstatements. Even if, in hindsight, it turns out that financial statements contained material misstatements, it may have been reasonable, at the time of the audit, for the auditor to conclude that they were accurate.

Misconceptions about the auditor's role are especially dangerous when it comes to fraud. Contrary to what many people believe, performing an audit isn't a guarantee that all fraud will be uncovered.

Expert's role

Accounting experts play critical roles in accounting liability cases. In addition to evaluating compliance with applicable standards, they can also address causation issues. Whether you're representing the plaintiff or the defendant, expert testimony by accounting and other financial experts is crucial to supporting your case. ■

FRE 702 amendment would clarify expert testimony standard

Federal Rule of Evidence (FRE) 702 is expected to soon be amended. Pending approval from the Judicial Conference, the U.S. Supreme Court and Congress, the changes would take effect on December 1, 2023. Here's how two critical amendments to the rule would address the misapplication of the standards for admitting expert testimony by many federal courts.

1. Applying the preponderance standard

The first proposed amendment makes clear that proponents of expert testimony must demonstrate to the court that it's "more likely than not" that the testimony meets FRE 702's admissibility requirements. This is the preponderance of the evidence standard that applies to most of the admissibility

requirements in the FRE, according to the Judicial Conference's Committee on Rules of Practice and Procedure.

The committee recognizes that some expert testimony challenges raise matters of weight, rather than admissibility. For example, a court may find it more likely than not that an expert has a sufficient basis to support an opinion. But the fact that the expert hasn't read every relevant study may raise a question of weight.



That doesn't mean, though, that arguments about the sufficiency of an expert's basis always go to weight and not admissibility — as some courts have held. Once a court determines the preponderance standard has been satisfied, any attack by the opponent will go only to the evidence's weight.

The committee also emphasizes that proponents don't have to show that their experts' opinions are correct. They need only show that the opinions are *reliable*. And FRE 702 requires only that the expert's knowledge will "help" the trier of fact understand the evidence or determine a fact at issue. Some courts have improperly required expert testimony to "appreciably help" the trier.

2. Gatekeeping expert opinions

Under the proposed changes, FRE 702(d) would be amended to highlight that each expert opinion must stay within the bounds of what can be concluded from reliably applying the expert's basis and methodology. Judicial gatekeeping is essential, but some courts have left this examination to the jury.

According to the committee, the amendment would be particularly relevant when it comes to the testimony of forensic experts in both criminal and civil cases. Such experts should avoid assertions

of absolute certainty, or to a reasonable degree of scientific certainty, if the methodology is subjective and, thus, potentially subject to error.

Where possible, a federal judge determining whether to admit forensic expert testimony should obtain an estimate of the known or potential rate of error of the methodology. Expert opinion testimony regarding the weight of "feature comparison evidence" (evidence that a set of features corresponds between two examined items) must be limited to inferences that can reasonably be drawn from a reliable application of the principles and method.

Note, though, that this amendment wouldn't impose any new or specific procedures. Nor would it require a court to "nitpick" an expert's opinion to reach a perfect expression of what the basis and methodology can support.

Stay tuned

As of this writing, these amendments to FRE 702 are awaiting final approval. In the meantime, it's worth noting that, because the amendments offer only clarification and emphasis, the preponderance standard already applies. Your FRE 702 motions should reflect that, regardless of whether the changes go into effect. ■

Use a rebuttal expert to break valuation deadlock

Financial experts use a variety of methods and inputs when valuing a business. So, it's common for two experts working in good faith to reach different conclusions. In such situations, litigating parties must find a way to resolve their differences. This is where rebuttal reports come in.

Identifying sticking points

Rebuttal reports can be useful in many cases, including divorces, shareholder disputes and mergers. They can help identify the sources of discrepancy between two expert opinions. This helps convert disagreements from complex questions about a business's value to a list of manageable issues.

For instance, after reviewing both experts' valuation reports, a rebuttal expert might conclude that their analyses are remarkably similar, except for some key differences. The sources of discrepancy might relate to, say, owners' compensation, the expected long-term growth rate and the discount for lack of marketability. Once these specific issues are identified, the parties can argue the merits of their experts' positions on these issues using objective market data.

In addition, rebuttal experts can quantify how specific issues, individually and combined, affect the valuator's conclusions. This analysis can help the parties systematically whittle away differences.

Finding the right format

Rebuttal reports come in various formats. What's appropriate depends on the time and resources available, as well as whether the parties are using a neutral third expert or the original valuator to generate the rebuttal report.

Written reports may vary in length. But they generally include a description of the rebuttal

expert's procedures and a list of findings and conclusions. Rebuttal reports should disclose *all* errors and omissions, not just those that support a client's financial interests.

Some experts and attorneys prefer oral rebuttals. The underlying logic is that less formal discussions generate no tangible report for the opposition to review before court. Accordingly, oral reports can help preserve the element of surprise and minimize client costs.

But there's a key downside to using oral rebuttals: Attorneys must understand technical financial and accounting issues well enough to design questions for deposition and trial. Incomplete testimony often misses key points and frustrates everyone involved. An oral rebuttal also leaves the judge or jury without a written record to review during deliberations.

Bridging the gap

Rebuttal reports are designed to facilitate settlement by pinpointing key differences between divergent expert opinions and putting technical valuation issues in more user-friendly language. This can help the parties find common ground, even in the most contentious cases. ■





Certified Public Accountants
Financial and Management Consultants

990 Stewart Avenue | Garden City, New York 11530

PRSR STD
U.S. POSTAGE
PAID
CHICAGO, IL
PERMIT NO. 4269

garibaldicpas.com

GARIBALDI GROUP

The **Garibaldi Group** takes accounting and financial management to a new level of responsiveness.

- Accounting, auditing and consulting for small to mid-sized closely held businesses and professional practices
- Business and professional practice valuations
- Forensic accounting, fraud engagements and expert witness testimony
- Tax planning and compliance
- Private wealth management
- Business, financial and estate planning

*Because at The Garibaldi Group,
it's our business to know your business.*

Now that's accounting done right!



Certified Public Accountants
Financial and Management Consultants

990 Stewart Avenue Garden City, New York 11530
Tel: 516.288.7400 • Fax: 516.288.7410 • garibaldicpas.com