



Advocate's Edge

Valuing the S corp

Is it worth more than a C corp?

Fifth Circuit breathes new life into FLPs

Electronic communications with CPAs:
Protecting privilege

Valuing family businesses
in divorce

November/December 2004

PLUS! Dealing with a spouse's tax fraud



Israeloff, Trattner & Co., P.C.

CERTIFIED PUBLIC ACCOUNTANTS • FINANCIAL CONSULTANTS

1225 Franklin Avenue • Garden City, NY 11530-7904 • (516) 240-3300

350 Fifth Avenue • New York, NY 10118-1099 • (212) 239-3300

www.israeloff.com

Valuing the S corp

Is it worth more than a C corp?

Tax rules differentiate the value between lots of things in life. So it should come as no surprise that tax laws are key to valuing S and C corporations.

In recent years, the U.S. Tax Court issued a trilogy of decisions that threw the valuation community for a loop by concluding that S corps carried more value than identical C corps. Uncertainty over the impact of these decisions continues today, and valuations of S corps should reflect this situation.

Tax-affecting

Prior to the cases of *Gross v. Commissioner*, *Heck v. Commissioner*, and *Adams v. Commissioner*, appraisers typically valued S corps as worth the same amount as C corps. To accomplish this, they reduced an S corp's earnings for corporate-level taxing (which S corps avoid, unlike C corps), a process known as tax-affecting.



Beginning with *Gross*, though, the Tax Court has indicated that S corps possess significantly more value than C corps because of their preferential tax treatment, making tax-affecting inappropriate.

The court's holdings in effect create a premium for the value of an S corp, which results in greatly increased tax liability. These cases have led some

to fear that the IRS will use the rulings to challenge S corp valuations, and not only those valuations prepared for gift and estate tax purposes.

Some experts have concluded that while S corps are worth the same amount as C corps — that are otherwise identical on an enterprise (or controlling interest) level — minority interests in S corps may vary in value from identical interests in C corps, due to differences in cash flow.

Implications

Most valuers agree that the propriety of tax-affecting an S corp's earnings should be determined on a case-by-case basis. Several factors will bear on the decision:

Distributions: The owner of a minority interest in an S corp can end up owing personal taxes on the business' earnings, a risk that might offset the need for a premium and support tax-affecting. If a business has a stable history of making sufficient cash distributions to its shareholders to cover their tax liabilities, however, the risk shrinks and a premium might be needed. Generally, a high payout ratio makes tax-affecting unnecessary.

Tax-affecting may, however, be required when the S corp earns a high net income but doesn't make adequate distributions to shareholders; the shareholders then must use their own money to pay the pass-through pro rata taxes on corporate earnings.

Likely buyers: Would a likely buyer create the risk of the business losing its S corp status? If so, the premium seems unnecessary, and tax-affecting should be applied. Further, the buyer of a minority interest is likely to be an individual, so, again, the premium wouldn't be needed.

On the other hand, the buyer of a controlling interest is likely a corporation, which would pay corporate-level taxes, so tax-affecting would be improper.

Restrictions in the shareholder agreement: Protective shareholder restrictions make it less likely that S corp status will be lost — in effect reducing the risk for shareholders. A premium may be necessary to reach an accurate value when an S corp has tight restrictions, so tax-affecting wouldn't come into play. Of course, the fact that shareholders want to hold onto the status doesn't guarantee they won't lose it, a factor to be considered in the valuation.

A tough decision

Whether to tax-affect the valuation when an S corp is involved isn't a simple, black-and-white question, but it should be addressed in performing the valuation and considered for inclusion in the valuation report. Qualified professionals will weigh all the factors and explain their decision in detail, increasing the odds their valuations will stand up in court. ✧

Fifth Circuit breathes new life into FLPs

A recent court ruling could give asset transfers between members of a family limited partnership (FLP) more muscle when challenged by the IRS.

The Fifth Circuit Court of Appeals has issued a decision broadly interpreting the bona fide sale exemption to Section 2036(a) of the Internal Revenue Code. The IRS has experienced some success using the statute to attack family limited partnerships in recent years, but *Kimbell v. U.S.* may provide taxpayers some defense in court.

The FLP battleground

Taxpayers sometimes use FLPs as a vehicle to limit the tax liabilities associated with transferring assets to the next generation, while retaining some control over the assets during their lifetimes. The IRS, however, has increasingly challenged FLPs, asserting that assets transferred to an FLP should be included in the transferor's taxable gross estate upon death.

IRC Section 2036(a) provides that a decedent's taxable gross estate should include the value of all property that the decedent transferred while nonetheless retaining during his lifetime:

1. The possession or enjoyment of, or the right to the income from, the property, or
2. The right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

To avoid inclusion in the gross estate, the taxpayer must show that either (1) the assets were transferred in a bona fide sale for adequate and full consideration, or (2) the decedent retained no possession or



enjoyment of, or the right to income from, the transferred assets.

The situation in *Kimbell*

Two months before she died, 96-year-old Ruth Kimbell created an FLP. A living trust, which she formed in 1991 with her son, held a 99% limited partnership interest in the FLP. A limited liability company (LLC) held a 1% general partner interest. Ruth owned 50% of the LLC, and her son and his wife owned the remainder.

The trust contributed about \$2.5 million in oil and gas business interests to the FLP in exchange for the limited partner interest, and Ruth retained \$450,000 in personal assets through the trust.

After Ruth died, the IRS conducted an audit and valued her 99% interest in the FLP at almost \$2.5 million, vs. the \$1.26 million the estate reported.



Classifying Ruth's assets

The appellate court focused most of its decision on the first exception to Section 2036 — whether the transfer of Ruth's assets to the FLP constituted a bona fide sale for adequate and full consideration. The government argued, and the district court agreed, that a transfer between family members couldn't be a bona fide sale.

The Fifth Circuit dismissed the notion that a transaction between family members can never qualify as a bona fide sale. It also noted that tax-planning motives alone do not prevent a sale from qualifying as bona fide if objective facts show the transfer was made for adequate and full consideration.

Instead, the court based the test for bona fide on whether (1) the transferor actually parted with her interest in the transferred assets, and (2) the FLP actually parted with the partnership interest issued in exchange.

The court held the test for "adequate and full consideration" requires an objective inquiry as to whether the exchange of assets for partnership interests is roughly equivalent, so the transfer doesn't deplete the estate.

It specifically rejected the government's attempt to use fair market value (FMV) as the test for adequate and full consideration, which would render illegitimate transfers where the limited partnership interest acquired carried an FMV substantially less than the FMV of the assets transferred.

The court ultimately articulated a three-prong test in which adequate and full consideration is determined by whether:

1. The interests credited to each partner are proportionate to the FMV of the assets each contributes to the FLP,
2. The assets contributed by each partner are properly credited to their respective capital accounts, and
3. On termination or dissolution of the partnership the partners are entitled to distributions in amounts equal to their capital accounts.

Kimbell findings

Despite the government's argument that the transaction represented "a mere recycling of value," whereby Ruth only changed the form in which she held her property, the court found the transaction had been entered into for substantial business and nontax purposes. It cited several factors supporting the transfer to the FLPs, including:

- ✓ Ruth's retention of sufficient assets for her own support,
- ✓ The lack of commingling of personal and FLP assets,
- ✓ Satisfaction of partnership formalities,
- ✓ The actual assignment of the assets to the FLP, and
- ✓ The need for the oil and gas interests transferred to be actively managed.

The court further found the FLP accomplished several business objectives that couldn't be achieved by the trust. It provided legal protection from creditors, reduced administrative costs and preserved the assets as the separate property of Ruth's descendants (thus protecting these assets from divorcing spouses).

The future

The IRS's recent successes with Section 2036 caused much concern over the continued validity of FLP transfers, but *Kimbell* shows that asset transfers can survive an IRS assault. With proper planning, FLPs can provide tax benefits, while reducing the likelihood of a successful IRS challenge. ✦

Electronic communications with CPAs: Protecting privilege

E-mail, cell phones, even faxes. Can you imagine conducting business without them? Such tools have gained a firm foothold in the practice of law in recent years. Some clients may even expect their attorneys to take advantage of electronic communications whenever possible *and* prudent. No one wants to lose attorney/client privilege as a result of using electronic communications.

But it's not just communications between attorneys and their clients that can jeopardize attorney/client privilege. An attorney can risk his client's privilege while communicating with a nontestifying consulting accountant, too.



The 1961 case *United States v. Kovel* established that attorney/client privilege extends to accountants under certain circumstances. That privilege can be lost, however, through the inadvertent disclosure of confidential information. As electronic communications become commonplace, attorneys and their consulting accountants need to take steps to avoid losing privilege due to inadvertent disclosure through electronic communications.

Privilege basics

Generally, a communication must satisfy several requirements to qualify for attorney/client privilege. It must:

- ✓ Be between an attorney and his/her client,
- ✓ Relate to the attorney's representation of the client,
- ✓ Be made in confidence, and

- ✓ Be reasonably protected from disclosure to third parties, both at the time it was initially made and after.

According to *Kovel*, the privilege also applies to communications with accountants if they're made "in confidence for the purpose of obtaining legal advice from the lawyer. If what is sought is not legal advice but only accounting service ... or if the advice sought is the accountant's rather than the lawyer's, no privilege exists."

Communications that qualify for privilege can lose that protection as a result of disclosure to an unauthorized third party. Although privilege technically lies with the client, the attorney (and the consulting accountant) can waive it.

Under Model Rule of Professional Conduct 1.6, attorneys must take reasonable steps to protect confidential information against unauthorized disclosure, including choosing a means of communication with a reasonable expectation of privacy.

Privacy's gray side

Determining whether a particular communication is entitled to attorney/client privilege is contingent on whether the communication offers a reasonable expectation of privacy. Different modes of communication bear different expectations of privacy, and attorneys should ensure that their consulting accountants understand these limitations prior to communicating via the following:

E-mail: E-mail frequently travels through numerous networks or computer systems to reach its destination, putting it at risk of interception by unauthorized parties lurking on the Internet. Regardless of this vulnerability, the American Bar Association (ABA) has approved the use of unencrypted e-mail to communicate with clients and others, including accountants, on client matters because it "affords a reasonable expectation of privacy."

Although the ABA has expressly condoned the use of e-mail for client communications, attorneys should still worry about inadvertently waiving protections.

According to an ABA survey, 70% of respondents who send confidential communications by e-mail rely solely on a confidentiality statement or disclaimer in the transmission to protect the confidentiality; fewer than 20% use encryption security, and 20% take no precautions at all. While somewhat pricey, encryption technology can protect against the waiver of privilege.



Cordless and cell phones: Conversations on traditional landline phones are protected as well. The question of cordless and cell phones falls into a gray area. Who hasn't picked up a wireless phone and found themselves listening to a strange third-party conversation?

Some courts have found no reasonable expectation of privacy in cordless phone conversations because the conversations

are broadcast as radio signals. Similarly, cell phone calls have been denied protection because scanning devices can intercept the calls. Until more concrete guidance is issued, it's best to avoid communicating confidential information to an accountant over cordless or cell phones. If you must, obtain client consent first.

Faxes: Faxes generally warrant protection because faxing uses landline technology. Consider adding a confidentiality statement to the cover sheet in case the fax is delivered to an unintended recipient.

Better safe than sorry

With electronic and wireless communication so common and readily available, taking precautions can seem cumbersome. But attorneys who fail to protect themselves and their clients can end up facing malpractice claims and disciplinary charges, so take the time to guard communications from inadvertent disclosure by anyone involved in the representation, including accountants. ✧

DEALING WITH A SPOUSE'S TAX FRAUD

Even a divorce decree can't protect an innocent spouse from liability associated with errors on a couple's joint tax return. A decree may state that one spouse will be responsible for any amounts due on previously filed returns, but the nonresponsible spouse still must request innocent spouse relief from the IRS.

RELIEF CONDITIONS

An applicant for relief must satisfy three requirements:

1. The applicant filed a joint return with a tax understatement due to erroneous items (that is, deductions, credits or bases incorrectly stated and any unreported income) by his or her spouse.
2. When the applicant signed the return, he or she didn't know, and had no reason to know, of the understatement.
3. Taking into account all the facts and circumstances, it would be unfair to hold the applicant liable.

In determining fairness, the IRS will likely consider whether the applicant received any significant benefit from the understatement or was later divorced from or deserted by the spouse. A benefit may be received directly or indirectly, as in a case where a spouse used unreported income to pay extraordinary household expenses.

If, at the filing date, the applicant knew of an understatement but not the actual figure, the applicant may qualify for partial relief, considering he or she didn't know or have reason to know the figure.

OTHER OPTIONS

Applicants must request relief within two years after the date the IRS first begins collection activity. If an applicant is denied innocent spouse relief, he or she may qualify for separation of liability or equitable relief.

Valuing family businesses in divorce

Valuing a family business can become a contentious and pivotal issue in a divorce case, so beware. Understanding the basic methods used to value a business, as well as the special considerations and nuances related to family-owned businesses, could expedite settlement processes.

Going concern values

So-called going concern valuation methods are applied to functioning businesses expected to continue operations. Three variations are used.

Comparable transactions: Under this method, the valuation professional looks for similar businesses that were recently purchased, ideally in the same business, area, size and year. The valuator's judgment plays a role because extrapolation is usually necessary, as it's difficult to find a truly comparable transaction.



Present value of future cash flows: The valuator looks at the business' historical performance and other factors to extrapolate future net income, which is then discounted to present value. Judgment again

becomes significant, from predicting future performance to selecting the appropriate discount rate.

Net asset value: The net asset value method is usually used only after the previous two methods have been rejected. It comes into play when a business technically remains a going concern, yet its value is really only its assets less its debts.

Liquidation methods are used far less often than going concern methods in divorce cases. The methods are limited to businesses that have discontinued operations or are expected to do so in the near future.

There are two types of liquidation methods, and both consider the remaining value after the business' assets are sold and its debts are paid. While the proceeds are rapidly realized, liquidation values tend to come in very low.

Significant discounts are applied to liquidation values to reflect the cut-rate prices required to sell the assets quickly. Under the forced sale method, each asset is valued based on the price it would earn at an auction or lot sale.

Buyers at these sales often buy most or all of the assets available, typically at discounts that can exceed 50%. The orderly sale method requires less dramatic discounts, assuming some steps will be taken to market the assets.

Special influences

Family businesses are susceptible to certain factors that can influence a valuation. For example, an owner/manager might be paid less than the rate or salary needed to hire a manager from the outside. A prospective buyer would incur greater expenses because he or she would need to pay a manager at the market rate.

In turn, if an owner takes or pays family members excessive compensation, net income is reduced. This can result in an artificially low value if not properly accounted for by the valuator.

Compensation also can influence alimony and child support calculations. Although a husband who runs a family business may not consider his country club membership or company as income, the court might disagree. Additional adjustments may be necessary if business and personal expenses have been intermingled.

Which method?

Valuators in divorce cases often use multiple methods to arrive at an accurate valuation of the family business, and the court may further consider the spouses' respective circumstances, such as the husband's income or the wife's employability outside of the business.

Understanding the particular business involved, the family members' situations and the valuation methods available should help reduce uncertainty and facilitate planning and settlement. ✧



Robert L. Israeloff



Arthur Sanders



Michael J. Garibaldi

Our comprehensive spectrum of services are designed to provide efficient and affordable solutions to the many complex issues facing the legal profession today. We can help a profit-oriented firm like yours identify and understand a full range of firm governance, partner compensation and profitability issues that will help you gain a competitive advantage.

Choose among the following services:

Firm Governance Issues

- Law firm management evaluation services
- Goal setting and performance evaluation systems
- Partnership agreements
- Management structures

Profit Improvement

- How to improve your law firm's bottom line
- Structuring the firm for growth and profitability
- Performance-based compensation
- Attorney productivity
- Billable time and realization

Strategic Planning & Marketing

- Strategic plan development
- Specialty newsletters and firm brochures
- Client satisfaction surveys
- Client development programs

Tax Planning & Compliance

- Tax planning for individuals, partnerships and professional corporations
- Personal financial planning

Litigation Support & Forensic Accounting

- Expert witness testimony
- Collection, interpretation and evaluation of financial data
- Business, Professional Practice & License valuations
- Bankruptcy and reorganization planning
- Damage Analyses
- Fraud Engagements

Accounting & Financial Reporting

- Internal control reviews
- Financial modeling and forecasting
- Accounting system design and implementation

Alternative Dispute Resolution

- Mediation
- Facilitation
- Arbitration
- Neutral Evaluations

Technology Consulting

- Hardware and software review and training
- Networking and systems administration
- Internet/Intranet site development
- Security

For Further Information call: Robert L. Israeloff, Arthur Sanders or Michael J. Garibaldi at (516) 240-3300 or (212) 239-3300.



Israeloff, Trattner & Co., P.C.

CERTIFIED PUBLIC ACCOUNTANTS • FINANCIAL CONSULTANTS

1225 Franklin Avenue, Garden City, New York 11530-7904

PRSRT STD
U.S. POSTAGE
PAID
PERMIT NO. 307
VALLEY STREAM, NY