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Viewpoint on Value

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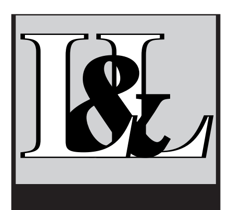

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How do innocent spouses spell relief?

Divorcing spouses frequently engage valuation experts to help divide their assets, particularly when the marital estate includes a private business interest. Not only does closely held stock complicate divorce proceedings, but it also provides opportunities for owners to underreport income or exaggerate expenses.

Dual incentives

A lower bottom line benefits a moneyed spouse in two ways. First, to the extent that a company's value is based on its earnings, reduced income lowers value. Therefore, low profits increase a moneyed spouse's share of the estate's remaining assets. Some moneyed spouses will even hide physical assets or use fraudulent accounting tactics to lower profits reported before their divorces.

{ Taxes often play a key role in splitting up the parties' estate and formulating maintenance payments. }

Beyond divorce proceedings, some private companies routinely minimize earnings to reduce their tax liabilities. When businesses operate as partnerships or S corporations, business income flows through to the owners' personal tax returns.

When the IRS uncovers tax deficiencies on a joint tax return, the government can pursue both spouses jointly or either spouse *individually* to collect the entire liability, regardless of which spouse is responsible for the error. In many instances, IRS attack occurs long after a divorce has been finalized.

Joint liability often seems unfair, especially in the aftermath of a difficult divorce. For instance, many nonmoneyed spouses are unaware of their former spouses' tax avoidance schemes. Others simply received no benefit from the hidden income or lack the financial wherewithal to pay the entire liability.

Expanded innocent spouse rules

Fortunately, Congress recently acknowledged this inequity and expanded the innocent spouse rules. Under the IRS Restructuring Act of 1998, innocent spouses now have three options to relieve them of a joint tax liability:

1. Innocent spouse relief — Internal Revenue Code (IRC) Section 6015(b). As with previous regulations, if a spouse can prove that he or she did not know or have reason to know of a tax understatement, the IRS may relieve the innocent spouse of the tax liability.

Understatements occur when the IRS discovers that income or revenue has been omitted, or when expenses, itemized deductions or credits have been exaggerated. But current law cannot relieve innocent spouses from underpayments, which occur when the parties have not yet paid a tax bill.

Innocent spouse relief is not a new concept and was formerly granted under IRC 6013(e). But the revised code eliminates the size limitations on eligible understatements and relaxes the standard required to assert innocence.

2. Separation of liability — IRC Section 6015(c). Divorced taxpayers can also elect to separate tax deficiencies (but not tax underpayments) based on the portion for which they are directly responsible. To be eligible for this form of relief, the electing spouse must not have actual knowledge of the understatement.

This election only limits the tax burden for the spouse making the

election. If the other party fails to make a similar filing, he or she will remain liable for the entire joint tax bill. To avoid unpleasant surprises, divorcées may want to consider automatically petitioning to separate their joint tax liabilities under IRC Section 6015(b).

3. Equitable relief — IRC Section 6015(f). If neither of the previous two methods relieves a spouse from an inequitable tax burden, the taxpayer can throw himself or herself on the mercy of the IRS. But keep in mind that the Tax Court has no jurisdiction over equitable relief claims.

Under this option, the IRS may forgive both tax understatements *and underpayments*. In addition to the petitioning spouse's knowledge of errors and underpayments, the IRS considers whether the spouse benefited from an understatement. It also considers whether the spouse can afford to pay his or her basic living expenses after paying the tax deficiency.

Taxing issues

Most valuators don't actually prepare tax returns for their divorcing clients. But taxes often play a key role in splitting up the parties' estate and formulating maintenance payments. To best serve their clients' needs, valuators who specialize in divorce have an in-depth understanding of tax issues, including the new innocent spouse rules.

Current tax law alters the balance of power between divorce courts and the Tax Court. The Tax Court has jurisdiction to review the IRS's assessment of a spouse's innocence. Consequently, Tax Court proceedings may resemble divorce hearings.

For instance, the IRS must inform the nonpetitioning spouse of any innocent spouse claims and allow the nonpetitioning spouse to present his or her side of the argument.

Divorced couples often have divergent views on the issues used to evaluate innocence, such as the nonmoneyed spouse's benefit from an understatement or his or her involvement in the business. So Tax Court trials may rehash many of the same issues that the divorce court addressed.

Implications of testimony

Remember, too, that testimony in divorce court may come back to haunt both parties. For example, suppose a nonmoneyed spouse, desperate to increase support payments, alleges that the business owner historically omitted cash receipts from the couple's joint tax return. Such testimony could subsequently be used against the petitioning spouse in determining innocent spouse relief.

Clients, attorneys and valuators need to be aware of current tax law and its implications to ensure the best outcomes in marital dissolution cases. ▮

WHAT DID THEY KNOW AND WHEN DID THEY KNOW IT?

Here are some questions the IRS may use to assess whether a spouse knew or had reason to know of an understatement:

- What was the nature and relative size of the error?
- What are the spouses' current and former financial situations?
- Did the petitioning spouse benefit directly or indirectly from the understatement?
- What are the petitioning spouse's levels of education and business acumen?
- What was the petitioning spouse's degree of participation in the activity related to the erroneous item?
- Would a reasonable person have questioned the erroneous item when signing or reviewing a joint tax return?
- Was the error a departure from the parties' previous tax reporting practices?

The answers to these questions can help determine whether the petitioning spouse is liable for the erroneous tax information.

Don't forget about management interviews

Interviewing management is an essential part of the valuation process. These question-and-answer sessions build rapport between valuation experts and company personnel. More important, interviews bring meaning to companies' two-dimensional financial reports and identify other external resources (such as trade associations or government agencies) from which appraisers can draw useful, objective data.

Scope of the interview

The purpose of a management interview is to provide the appraiser with a greater understanding of the company's operations as well as its external environment. The interview may encompass a broad range of topics, including the company's:

- Business history,
- Product and service offerings,
- Operations and production,
- Contractual arrangements,
- Insurance coverage,
- Discontinued operations,
- Technology,
- Marketing and sales,
- Accounting and finance,
- Industry trends,
- Prior stock transfers or purchase offers,
- Related-party transactions,
- Off-balance sheet or nonoperating items, and
- Intangible assets.

To protect themselves against factual omissions and client misrepresentations, valuators customarily conclude management interviews with a catch-all question. For instance, they may ask, "Do you know of anything else that we've forgotten to discuss today that may affect your company's value?"

Arranging the interview

Too often, attorneys and clients fail to appreciate the benefits of formal management interviews. Some managers resist interviews because they are too busy or highly protective of their companies' proprietary information.

In highly confidential or sensitive cases, such as a potential sale or bankruptcy proceedings, the manager may worry that the presence of an outside professional asking a lot of questions could raise suspicion among the company's employees.

Arranging management interviews is even more difficult in adversarial situations, such as dissenting minority shareholder or marital dissolution cases.

But failure to interview management can severely compromise the reliability of a valuator's conclusions. When using valuators for litigation purposes, attorneys should consider petitioning the court to mandate formal on-site management interviews. If

the opposition vehemently resists this request, the court may suspect that they are hiding something.

Understanding interview basics

Before requesting a court-mandated interview, attorneys should first understand how management interviews typically work. A detailed court petition addresses the scope, location and timing of a management interview. (See "Scope of the interview" on page 4.)

Location. To enhance their understanding of the company's operations, most valuators prefer to conduct on-site interviews, usually performed in conjunction with a tour of the facilities.

When denied an on-site interview, appraisers may settle for other, less preferable alternatives, such as telephone interviews, face-to-face discussions at a neutral location (such as a local restaurant or the attorney's office), or written questionnaires to be filled out by management (and presumably reviewed by corporate counsel).

Timing. Before crunching the numbers, valuators need a thorough understanding of the company's operations and relative risk factors. Because management interviews serve as fact-finding missions, they should ideally occur as early in the valuation process as possible.

But interviews may be delayed for a variety of reasons. For instance, management may oppose the procedure or the parties may initially put off formal interviews until they've lost all hope for an out-of-court settlement. In other cases, the valuator may postpone the interview to ensure that it takes place as close to the valuation's "as of" date as possible.

Preparing for the interview

To conduct a productive and useful interview, preparation is key. Valuators typically prepare themselves by doing preliminary research. For instance, they might visit the company's Web site, scan its financial statements and prepare a list of questions geared to its situation.

This initial legwork ensures that interviews are as painless, efficient and effective as possible. ▮

Every business is a risky business

Every business faces risks, but some companies are riskier than others. Assessing a company's risk is an important part of estimating its value. Risk and value are inversely related. That is, the higher a company's risk, the lower its value.

Risk is a function of a company's external threats and internal weaknesses, but these forces only tell part of the story. On the flip side, a business's strengths and opportunities minimize risk and, therefore, build value.

When valuators focus exclusively on one side of the story, their conclusions are likely to be skewed. For example, to minimize an estate's tax burden, an appraiser might unduly emphasize a company's weaknesses and threats in order to justify excessive valuation discounts.

Conversely, the IRS's expert might downplay these negative elements and, instead, call attention to the business's strengths and opportunities.

Framework for evaluating risk

Providing a complete, accurate depiction of a company's future performance requires the valuator to consider both positive and negative aspects of its operations. A strengths, weaknesses, opportunities and threats (SWOT) analysis provides a four-pronged

KEY EXTERNAL FORCES THAT AFFECT VALUE

The macro-environment

- National and local economic conditions
- Social and cultural trends
- Political factors
- Environmental policies
- Government regulations
- IRS rules
- GAAP (generally accepted accounting principles) revisions

Industry forces

- Level of competition
- Substitute products
- Technology
- Licensing and capital requirements
- Power of customers and suppliers

framework for analyzing risk that links a business's internal strengths and weaknesses to the opportunities and threats in its external environment. This popular tool helps valuators organize their thoughts and provides a holistic risk assessment.

1. External forces: opportunities and threats. Before jumping head first into a company's financial performance and operations, the valuator assesses the external environment in which a company operates. Opportunities are favorable conditions that — if exploited — may enhance shareholder value. Alternatively, threats are barriers that jeopardize future performance.

> Is the company taking advantage of potential opportunities and exploiting its strengths?

In many cases, management has little control over these external factors. (See "Key external forces that affect value" above.)

2. Internal forces: strengths and weaknesses. After the valuator understands the company's external forces, he or she is ready to identify its internal strengths and weaknesses relative to its competitors'.

Strengths are competitive advantages or core competencies that enhance value. In contrast, weaknesses restrict the company's performance.

To complicate matters, strengths and weaknesses sometimes overlap. Consider former Disney CEO Michael Eisner as an example. Although he fueled the company's financial revival in the late 1980s and 1990s, Eisner's inability to train a suitable successor has depressed the entertainment giant's stock in recent years.

3. Strategic management. During the valuation process, the valuator also addresses whether a company recognizes and manages its strengths, weaknesses, opportunities and threats.

Are the company's short- and long-term goals congruent with these factors? Does management plan to mitigate threats and correct weaknesses? Is the company taking advantage of potential opportunities and exploiting its strengths?

A company's value can be adversely affected if management is unaware of these internal and external factors or if management fails to incorporate them into its strategic plans.

4. Impact of information on value estimate. Finally, valuators use the information obtained from their analyses to help them:

- Select the appropriate valuation technique,
- Forecast future income streams,
- Decide on relevant selection criteria and other subjective adjustments under the market approach,
- Build discount and capitalization rates when using the income approach, and
- Quantify valuation discounts, such as discounts for lack of marketability and control.

Review and investigate

In adversarial situations, a valuator's subjective decisions may come under attack. Attorneys and clients need to review valuators' written reports to ensure that all risk factors have received adequate attention.

They should also investigate exactly how these risk factors affect the appraiser's mathematical computations and assess whether any factors have been double-counted. Above all else, a valuator's subjective decisions should be well supported and reasonable. ∎

PICKING THE RIGHT PRICING MULTIPLE

The income approach has long been a favorite valuation technique among appraisers. But other methods, in particular the market approach, also have merit. In fact, many judges actually prefer the market approach for its perceived objectivity and simplicity.

What is the market approach?

Under the market approach, a valuator derives a private business's value by comparing it with the actual sales prices of similar private or public companies involved in a transaction. While this approach may seem straightforward, choosing the appropriate pricing multiple can be challenging.

Valuators select from a varied menu of pricing multiples. Among the most common choices are:

- Price-to-earnings,
- Price-to-earnings before taxes,
- Price-to-earnings before interest expense, taxes, depreciation and amortization,
- Price-to-discretionary-income (with varying definitions),
- Price-to-gross-profits,
- Price-to-net-sales, and
- Price-to-book-value.

Which pricing multiple is best?

For years, appraisers have been searching for a universally optimal pricing multiple. In this pursuit, different valuation experts have occasionally endorsed one pricing multiple as superior to all others.

For instance, some appraisers feel that the price-to-net-sales multiple produces the most reliable valuation results, because profit metrics are inconsistently defined and subject to manipulation. Others advocate using the price-to-gross-profits multiple, finding that it often has the highest correlation with sales price.

What's the magic answer?

The truth is, no pricing multiple is perfect for all clients. For example, price-to-gross-profits may have high predictive power, but may not be the best choice when valuing a hair salon or an accounting firm, where individual skills are most important and material costs are minimal.

Because each valuation assignment is different, appraisers make subjective judgments when selecting pricing multiples. To illustrate, price-to-book-value may make more sense when valuing an asset-holding company or an asset-intensive business in which book values reasonably approximate current market values.

Conversely, when valuing small businesses (under $5 million in annual revenues), price-to-discretionary-income may be more meaningful, because it mirrors small company merger and acquisition practice and generally addresses the desire to reduce income tax expenses.

What should a valuator consider?

In selecting any multiple, the valuator considers the subject company's industry and size as well as its specific value drivers. When done well, the valuator's report will fully explain and defend the pricing multiple selected.

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John M. Leask, II (Mac) values between 20 and 50 businesses annually for a variety of reasons. **He has done valuations to support estate and gift tax returns and has testified as an expert witness in divorce cases and shareholder disputes. Most often, Mac's valuations are done in conjunction with the purchase or sale of a business** — to assist shareholders or to set values when shareholders purchase the interest of a retiring shareholder. Recent examples of valuation engagements include a valuation done to support a pre-nuptial agreement and a valuation of a franchise business prior to purchase. Here are some more specifics about the types of engagements Mac performs:

- **Due Diligence & Assisting in the Purchase of a Business:** Mac has assisted the purchasers of businesses by determining or reviewing the offer. He is often called upon to help negotiate the purchase price and perform due diligence. These services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, and identifying critical issues relating to the future success of the businesses.
- **Family Limited Liability Partnerships/Companies & Closely Held Businesses:** Mac is regularly called upon to value various sized business interests for estate and gift tax purposes. He provides assistance to estate and trust experts during audits of reports prepared by other valuators.
- **Expert Witness in Divorce & Shareholder Disputes**

More information about Leask & Leask's valuation services (including case studies) may be found at our firm's web site (www.leask.com).

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