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Discounting majority interests

Tax Court tackles valuation of real estate LLCs

A recent U.S. Tax Court case addressed the valuation of majority interests in five real estate holding companies for estate tax purposes. *Estate of Warne* involved several valuation issues. Perhaps most significantly, the court held that, when a 100% interest is split for purposes of charitable contribution, its *full* value is includable in the taxable estate. But the estate's charitable deduction is limited to the *discounted* values of the fractional interests received by the charities.

Decedent wielded considerable control

The decedent owned majority interests in five limited liability companies (LLCs) that held ground leases and certain other interests in various California properties. The LLC interests were held in a family trust. Although the decedent had given fractional interests in most of the LLCs to family members, the trust retained majority interests, ranging from 72.5% to 100%, in each of the companies.

As trustee, the decedent served as the managing member of each LLC. Accordingly, she held considerable power over them, including the power to unilaterally dissolve them.

The family trust owned a 100% interest in one LLC (Royal Gardens). In an amendment to the trust, the decedent left 75% of Royal Gardens to a family foundation and the remaining 25% to a church.

Charitable mismatch

The parties agreed on a value of $25.6 million for the estate's 100% interest in Royal Gardens. But they disagreed on the values of the interests donated to charity. The estate had reported their values at $19.2 million and $6.4 million, respectively, for a total charitable deduction of $25.6 million. This total offset the amount included in the estate.

Conversely, the IRS reduced the deduction to $21.4 million to reflect valuation discounts applicable to the two fractional interests. The court accepted the IRS's approach, finding that the charitable deduction for property split among several charities is the value of what each charity receives, rather than the value of the property as a whole.

Spectrum of control

To value the LLCs other than Royal Gardens, experts for both parties used an adjusted net asset value approach. However, they disagreed over the calculation of the discount for lack of control (DLOC).

To calculate the DLOC, the estate's expert used the Mergerstat control premium study. He compared control premiums paid to acquire 50.1% to 89.9% controlling interests with those paid to acquire 90% to 100% interests. The expert said the difference — 9.47% — reflected a possible discount for controlling interests that lacked "total control."

Consider market conditions when estimating damages

When financial experts calculate economic damages, they estimate what the plaintiff's financial results would have been "but for" the defendant's alleged wrongdoing. However, failure to consider the impact of external market conditions on the plaintiff's financial performance can cause experts to overstate or understate damages.

Suppose an expert estimates lost revenue by comparing the plaintiff's profits before and after the defendant's alleged wrongdoing. The assumption is that the defendant's conduct caused the decrease in revenue. But if external market forces contributed to the plaintiff's depressed performance, this approach may not necessarily be appropriate.

For example, say a wrongful act occurred just before the COVID-19 pandemic. Depending on the pandemic's impact on the plaintiff's business, its historical financial results may not be a reliable indicator of its future performance. If the plaintiff's revenue would have fallen even without the defendant's wrongdoing, the before-and-after approach would *overstate* its damages. On the other hand, if the pandemic had a positive impact on the plaintiff's business, this approach would *understate* its damages.

Under these circumstances, it may be preferable to use the yardstick method, which compares the plaintiff's revenue to those earned by similar businesses not affected by the defendant's wrongdoing. Also, regardless of the method used, an expert must consider the impact of external market conditions — positive or negative — on the plaintiff's costs when calculating lost profits.

The estate's expert considered factors specific to the subject LLCs, such as the potential for costly litigation should the majority owner attempt to dissolve and liquidate them. Based on this analysis, he arrived at a DLOC of 5% to 8%.

The IRS's expert analyzed closed-end real estate funds to estimate the DLOC. The funds exhibited discount rates ranging from 3.5% to 15.7%, with a median rate of 11.9%. Because the closed-end funds represented minority interests "completely devoid of any control," the expert chose a 2% discount based on the "bottom of the range."

In similar cases, the Tax Court has held that no DLOC applied. But, in this case, the court decided to accept a "slight" discount, given the parties' agreement on the issue. It rejected the IRS expert's analysis, however, finding that the closed-end funds were too dissimilar to the subject LLCs and the data didn't apply to majority interests.

Although the court found that the estate expert's method was sound, it disagreed with the use of a higher discount to account for the risk of litigation. In the absence of evidence that minority owners would pursue litigation if the majority owner dissolved an LLC, the court reduced the DLOC to 4%.

No bright line rules

The application of DLOCs is a gray area in business valuation. Control isn't an all-or-nothing issue, so your expert must carefully evaluate the circumstances to determine what's appropriate. Contact a credentialed valuation professional to help avoid costly pitfalls when valuing assets for estate tax purposes. ■

Maginnis v. Maginnis

Court addresses apportionment of goodwill in divorce

Goodwill is the value of a business in excess of its net assets. It's generally derived from a business's name, reputation, customer loyalty, location, products and other factors that attract customers. A question that often arises in divorce cases is: To what extent should goodwill be included in the marital estate? A recent decision from the Court of Appeals of Kentucky addresses this issue.

2 types of goodwill

Many businesses — especially smaller ones — have two types of goodwill. First, *enterprise* goodwill is associated with the business as an entity, apart from any specific owners. This type of goodwill can generally be sold to a third party. Second, *personal* goodwill is attributable to an individual owner's reputation, skills, education and experience. It's inextricably tied to the individual owners and generally isn't transferrable.

In divorce cases involving a business owned by one or both spouses, the treatment of goodwill varies from state to state. The majority view is that enterprise goodwill is a marital asset subject to division, while personal goodwill is not. Some states treat all goodwill as a marital asset, while others exclude goodwill from the marital estate.

Case summary

In *Maginnis*, the appellate court remanded the determination of the value of the couple's chimney sweeping business to the family court. The family court had, among other missteps, failed to address the apportionment of goodwill between personal and enterprise goodwill pursuant to the Kentucky Supreme Court's decision in *Gaskill*.

> ***Personal goodwill is attributable to an individual owner's reputation, skills, education and experience.***

At trial, the court refused to permit the husband's valuation expert to testify, finding that he had failed to adequately disclose "the substance of the facts and opinions to which [the expert was] expected to testify and a summary of the grounds for each opinion." In dividing the marital property, the court adopted a value of roughly $284,000 set forth by the wife's expert and ordered the husband to pay the wife half of the company's value.

However, the wife's expert stated that 70% of the company's value was attributable to the husband's personal goodwill — and, therefore, not subject to division. The court ignored this analysis. It also awarded the wife $3,300 per month in maintenance "until she remarries, cohabits or dies."

The appellate court upheld the family court's exclusion of the husband's expert. But it also ruled that the lower court erred in not addressing the treatment of goodwill. On remand, the appellate court instructed the family court to consider the wife's expert's conclusions regarding personal and enterprise goodwill and to either:

- Accept them and apportion the company's value accordingly, or
- Reject them and provide a sufficient explanation for doing so.

In reaching this conclusion, the appellate court rejected the wife's argument that *Gaskill* was inapplicable because it involved the valuation of a professional practice. The court found no explicit indication in *Gaskill* that it was intended to apply only to professional practices. Indeed, the Kentucky Supreme Court relied heavily on the Indiana Supreme Court's decision in *Yoon*, which repeatedly referred to valuing "a business or practice."

Double dipping

The husband argued on appeal that the family court erred in awarding maintenance to the wife. By treating the entire value of the business — including personal goodwill — as marital, the husband said, the court had essentially attached his future earnings, so that an award of maintenance amounted to double dipping.

Although the appellate court vacated the maintenance award as part of its remand order, it noted that the husband's argument was "well taken" and advised the family court to keep these issues in mind when dividing the business and awarding maintenance.

Lesson learned

The proper treatment of goodwill in divorce varies based on case facts, state law and relevant legal precedent. It's critical to work with a valuation professional to help determine what's right for a particular business interest. In some situations, legal precedents from other states may provide helpful guidance. ■

How financial experts solve the mystery of hidden assets

In many litigation contexts — such as marital dissolutions and fraud investigations — one party may have a financial incentive to hide personal assets or income. Identifying and quantifying these undisclosed or underreported items can be challenging. Fortunately, financial professionals know where to look and how to quantify what's missing.

Searching for clues

Experts often start their searches with a net worth analysis that looks at changes in a person's worth, reconciling those changes

with income and expenses. The first step is to reconstruct this data, which may involve some detective work. Experts search for clues in a variety of places, including:

- Bank records,
- Real estate and court filings,
- Payroll records,
- Expense reports,
- Phone bills,
- Insurance documents, and
- Credit reports.

Employment and loan applications also can provide insights, including current and previous residences, family members' names, and previous jobs. Experts then interview people such as the subject's accountants, former spouses, former business partners and real estate agents.

Analyzing financial data

One approach to detecting hidden assets is to compare the subject's net assets at the beginning of the year to those at year end, adding known income and subtracting known expenses. A result other than zero indicates income from unknown sources.

Another approach is the expenditures method. Here the expert looks for discrepancies between the subject's expenditures and his or her sources of funds — including salaries, commissions, investment dividends, inheritances, loans, gifts and cash on hand at the beginning of the year. If the subject's spending exceeds the available funds, an unknown source of funds exists.

Complicating matters, however, is the fact that many people pay cash for expenses such as entertainment and meals and don't keep the receipts. And if it appears that the subject is using skimmed funds to pay for cash items, a more in-depth investigation will be necessary.

A third way to uncover hidden assets lies in a careful examination of bank deposits. This method relies on the assumption that all money is either spent or deposited. The expert starts with net deposits to all accounts during the year and adds cash expenditures to arrive at total receipts for the year. If that amount exceeds funds from known sources, the difference represents an unknown source of funds. Bank-deposit scrutiny is particularly appropriate with cash-intensive businesses.

Examining tax records

Tax return schedules also can contain a wealth of useful information. For example, Schedule A (itemized deductions) covers real estate and personal property taxes. The expert checks that reported amounts correspond to the underlying property. If they don't, further investigation may lead to undisclosed assets. Whether the subject has incurred alternative minimum tax liability could also be revealing.

If the subject's spending exceeds the available funds, an unknown source of funds exists.

Entries regarding state and local taxes may reveal income (or income-producing property) in other states. Experts can also glean critical information from Schedules B (interest and ordinary dividends), C (profit or loss from business), D (capital gains and losses) and E (supplemental income and loss).

Benefit of the doubt

When it comes to hidden assets, the natural inclination is to blame someone. While a contentious lawsuit may lead one party to wrongfully hide items of value, assets sometimes are obscured by conventional asset protection measures — and no wrongdoing has necessarily occurred. A financial professional can help you achieve full and complete disclosure. ■

Accounting 101: Levels of assurance

A financial expert's analysis is only as reliable as the data it's based on — and all financial statements aren't created equal. The term "assurance" refers to how confident (or assured) you are that a company's financial reports are reliable, timely and relevant. Here are three distinct levels of assurance that CPAs offer, in order of increasing level of rigor:

1. Compilations and preparation services. These engagements provide *no* assurance that financial statements are free from material misstatement and conform with Generally Accepted Accounting Principles (GAAP). With a compilation, the CPA puts financial information that management generates in-house into a GAAP financial statement format. Footnote disclosures and cash flow information are optional.

Alternatively, when financial statements will be used for internal purposes only, a CPA might *prepare* the company's financial statements in conjunction with bookkeeping or transaction-processing services. This is no different from what an in-house controller or CFO would provide to management. Prepared financial statements may be shared with outside parties, but each page of the statements will include a notice that "no assurance is provided."

2. Reviews. These statements provide *limited* assurance that they're free from material misstatement and conform with GAAP. Here, the accountant applies analytical procedures to identify unusual items or trends in the financial statements. He or she inquires about anomalies, as well as the company's accounting policies and procedures.

Reviewed statements include footnote disclosures and a statement of cash flows. But the accountant isn't required to evaluate internal controls, verify information with third parties or physically inspect assets.

3. Audits. These statements offer a *reasonable* level of assurance — but not a guarantee — that the financial statements are free from material misstatement and conform with GAAP. The Securities and Exchange Commission requires public companies to have an annual audit. Larger private companies also may opt for this service to satisfy outside lenders and investors. Audited financial statements are the only type of report to include an express opinion about whether the financial statements are fairly presented and conform with GAAP.

Beyond taking the analytical and inquiry steps of a review, auditors evaluate internal control systems, tailor audit programs for potential risks of material misstatement and report on control weaknesses when they deliver the audit report. In addition, they may conduct third-party verifications, physical inspections, and detailed examinations of original source documents and computer records.

Reliability matters

Financial statements may be used to value a business or estimate lost profits. Too often, a company's owners and counsel assume that a CPA's work always carries an independent audit's stamp of approval. But that can sometimes be a faulty assumption. ■

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