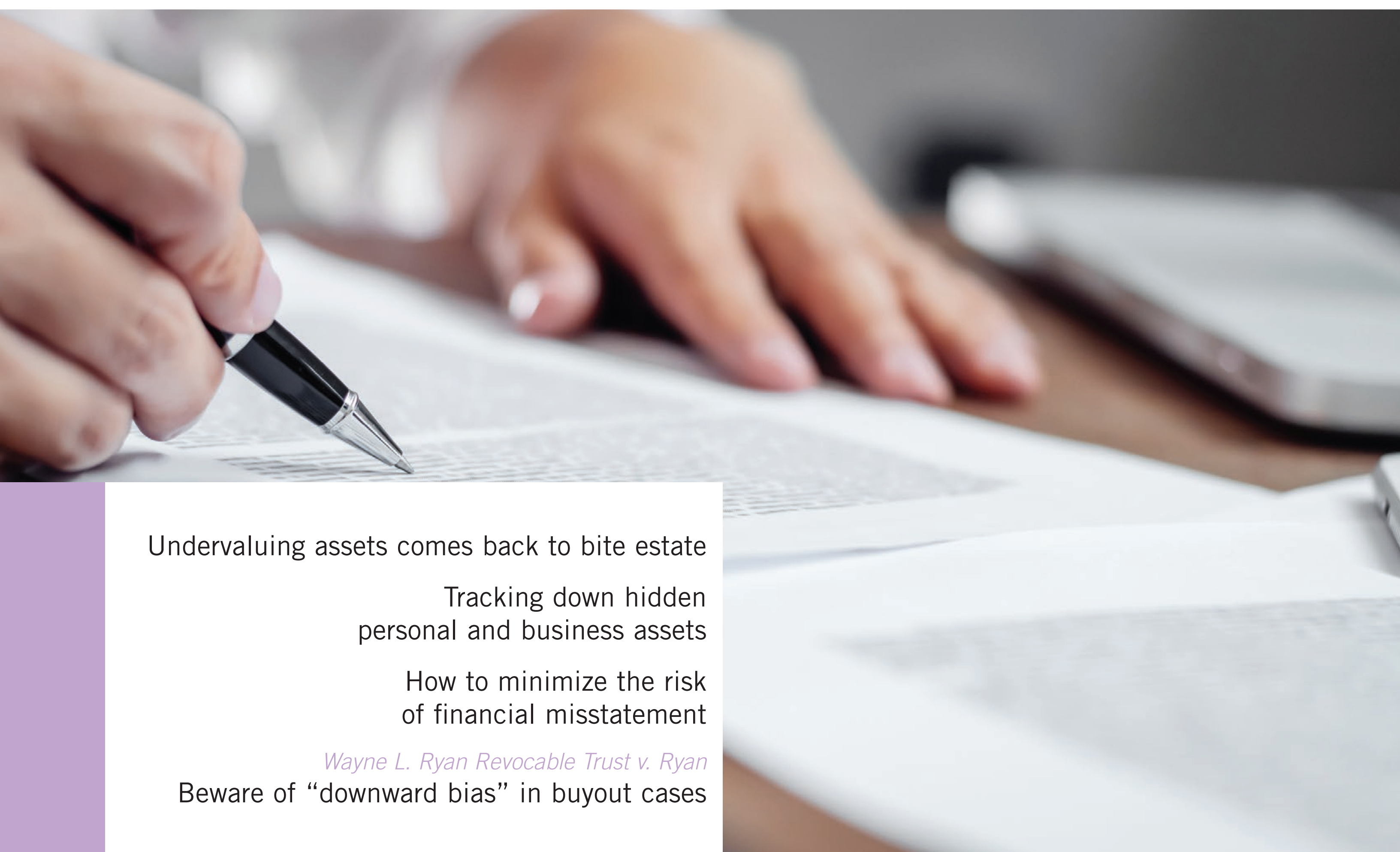
NOVEMBER/DECEMBER 2021

# LITIGATION SUPPORT



Undervaluing assets comes back to bite estate

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*Wayne L. Ryan Revocable Trust v. Ryan*
Beware of "downward bias" in buyout cases

# Undervaluing assets comes back to bite estate

Valuation matters are critical in gift and estate planning. In *Estate of Morrissette v. Commissioner*, the U.S. Tax Court has characterized the estate's valuation of split-dollar rights as a "gross valuation misstatement." In doing so, it upheld a hefty penalty for the undervaluation.

## Dynasty trust

In 2006, the decedent created a dynasty trust — generally, a long-term trust established to pass wealth to subsequent generations without incurring transfer taxes — for each of her three sons. Her revocable trust subsequently entered into two split-dollar agreements with each dynasty trust. The revocable trust contributed about $30 million to the dynasty trusts to pay the premiums on life insurance policies on the sons' lives. The arrangements were part of an overall plan to keep the family business in the family.

The revocable trust was entitled to receive part of the death benefit from a policy, equal to the greater of the policy's cash surrender value or the aggregate premium payments on the policy. The respective dynasty trust would receive the remainder of the death benefit, which would be used to fund the purchase of the deceased son's stock in the family business. After the decedent died, the split-dollar agreements were terminated, but the underlying life insurance policies weren't canceled.

Before her death, the decedent reported the contributions for premiums as gifts to her sons. Later, the IRS found an estate tax deficiency of about $39 million, based on her contract rights in the split-dollar life insurance arrangements. The estate reported a value of about $7.5 million, but the IRS valued them at $32 million, based on the cash surrender value of the underlying insurance policies.

## Steep penalty

The estate's undervaluation proved particularly costly, as the court found the estate liable for a 40% penalty for the gross valuation misstatement of the split-dollar rights. A gross valuation misstatement exists if the value reported on the estate tax return is 40% or less of the correct value.

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If the taxpayer acted with reasonable cause and in good faith, a penalty won't apply, though. The Tax Court explained that the most important factor in this defense generally is the taxpayer's efforts to ascertain its tax liability. Reliance on professional advice can provide a reasonable cause defense if,

## IRS gets a "Bad" verdict in Jackson case

The U.S. Tax Court recently settled a high-profile battle between dueling experts over, among other things, the appropriate value for the image and likeness of the late pop superstar Michael Jackson. Though Jackson first gained fame as a child, the court noted his fame "was turned infamous by serious accusations of the most noisome acts" as an adult.

At trial, the estate's experts calculated a value of $3 million, taking into account the 30 years preceding Jackson's death. At the time of Jackson's death, his image and likeness weren't producing any noticeable income, and he hadn't been able to contract for merchandise for his upcoming tour. He was in deep debt and hadn't toured or released an album in years.

The IRS expert computed a value of $161 million, based on several so-called "foreseeable opportunities" a hypothetical buyer would consider at Jackson's death. These opportunities included themed attractions and products, a Cirque du Soleil show, a film, and a Broadway musical.

The court reached a value of about $4.1 million, based largely on the calculations of the estate's experts. It dismissed the IRS expert's testimony because he:

- Valued the wrong asset, including intellectual property rights, which California excludes from the definition of image and likeness,
- Included unforeseeable events in his valuation, glossing over the multiple accusations of criminal acts against Jackson in his analysis of each supposedly foreseeable revenue stream, and
- Miscalculated the value by, for example, failing to incorporate expenses associated with the management of Jackson's image and likeness.

Conversely, the estate's experts gave proper weight to the effect of the allegations against Jackson on his ability to market his image-and-likeness rights preceding his death. It's fundamental, the court said, that property is valued for estate tax purposes as if "in the decedent's hands at the time of its transfer by death."

under the circumstances, the reliance was reasonable and in good faith.

When a taxpayer relies on an appraisal as a defense against a valuation penalty, the court considers:

- The methodology and assumptions underlying the appraisal,
- The appraised value,
- The circumstances under which the appraisal was obtained, and
- The appraiser's relationship to the taxpayer.

Here, the court ruled that the appraised value wasn't reasonable, and the brothers should have known it wasn't after they had the revocable trust pay $30 million for life insurance premiums. They entered the split-value agreements as an estate tax-saving strategy, and they knew when they opted to enter the agreements that any tax savings depended on valuing the split-dollar rights at a substantial discount from the premiums paid.

Further, a tax and estate planning attorney warned one of the brothers that the IRS would likely have a problem with the values of the split-dollar rights the estate planned to report. Yet, the brothers had the estate report substantially discounted values.

### Not worth it

The estate's attempt to avoid taxes by undervaluing the split-dollar rights clearly backfired. At 40% of the underpayment attributable to the valuation misstatement, the penalty in this case will prove significant. ■

# Tracking down hidden personal and business assets

To achieve a fair and equitable resolution in a divorce case, it may be necessary to trace assets and income that a spouse has hidden to reduce child support, alimony liability or the final settlement amount. You don't have to go it alone, however. Forensic accountants can sift through the data to help reveal hidden assets and income.

## Lifestyle analysis

A popular tool for finding hidden personal assets and income is lifestyle analysis. This method starts with financial profiling. Forensic accountants develop a financial profile by examining three key sources:

**1. Bank deposits.** The expert reconstructs income by analyzing bank deposits, canceled checks and currency transactions, as well as accounts for cash payments from undeposited receipts and non-income cash sources, such as gifts and insurance proceeds.

**2. Expenditures.** Here, the expert analyzes the sources and uses of cash during a given time period. If more is spent than is taken in, the excess likely is unreported income.

**3. Assets.** Experts assume that unsubstantiated increases in net worth reflect unreported income. To estimate net worth, an expert reviews bank and brokerage statements, real estate records, and loan and credit card applications.

Once the financial profile has been developed, the expert looks for mismatches between known resources and lifestyle. Tracing unreported income to assets or accounts that can be used to support a legal claim or enforce a judgment can be challenging. To do this, forensic accountants may scrutinize the assets noted above, as well as insurance policies, court filings, employment applications, credit reports and tax returns.

## The business angle

When a marital estate includes a closely held business interest — particularly if the business is controlled by one spouse — the opportunities to hide assets and income abound. Forensic accountants usually deploy the same asset-tracing techniques they use to detect occupational fraud.

The starting point is typically a search for suspicious payments that could indicate a business is stashing assets for its owner. These payments ostensibly represent business expenses. But they could actually represent money transferred into the owner's pocket and away from disclosed bank accounts. To find these payments, the expert collects various financial documents from the

business, such as bank statements, purchase orders, invoices and payment records.

A business owner also might recruit third parties, such as vendors or fictitious “ghost” employees, to assist in asset-hiding schemes. For example, the company could issue a check to a vendor in an amount greater than actually owed, with the vendor returning the excess as cash. Vendor accounts with no tangible deliverables — for consultants, commissions and advertising, for example — receive special attention, as do multiple vendors with the same address. Ghost employees may be found by reviewing payroll lists, current and former employee lists, personnel files, and employment applications.

In addition, spouses attempting to hide assets may fraudulently drive down their business’s income to reduce the company’s net income — and value as a marital asset. For example, a business owner might purchase personal assets (such as cars and real estate) or cover expenses (like cell phone bills and insurance premiums) with business funds.

To find hidden income, an expert scrutinizes the business’s actual expenses and expected sales associated with that level of expenses, accounts receivable and journal entry writeoffs. He or she also examines the business’s internal controls and the spouse’s ability to override them, the company’s markup structure, and the associated expected profitability. Large or unusual accounts receivable credits or sales returns usually merit further investigation.

### Out of the darkness, into the light

In a divorce, you must shine a light on every financial corner — particularly when a spouse has had limited access to the couple’s financial information during the marriage. Uncovering hidden income and assets is likely to help your clients receive the settlement and support they deserve. ■

# How to minimize the risk of financial misstatement

Whether intentional or inadvertent, material misstatements can mislead investors and lenders who rely on them to make important business decisions. Here are some warning signs to watch for and ways clients can prevent misstatements from happening in the first place.

### Evaluate current conditions

The risk of financial misstatement is currently high for many reasons. Management may feel pressure to disguise poor financial performance during the COVID-19 pandemic. In addition, in-house accounting personnel may not be familiar with recent changes to the rules for reporting contract revenue, leases and credit losses.

Plus, some items on the financial statements — such as allowances for bad debts, warranties and fair value measurements — may be based on management’s estimates. And the assumptions underlying these estimates might not be predictable in today’s volatile markets.

### Recognize red flags

A key warning sign of financial misstatement is unexpected *delays* in the reporting process. Why?

No one likes to be the bearer of bad news. Plus, it can take time to finagle the numbers to achieve a desired outcome.

Other signals of potential impropriety include:

- Lack of internal controls, such as segregation of duties and management review procedures,
- Managers who become defensive when questioned about complex transactions or questionable practices,
- Inexperienced or overworked accounting personnel,
- Performance-based compensation arrangements, such as profit sharing and bonuses,
- Changes in accounting methods from prior periods,
- Large adjusting journal entries at year end, especially if they're subsequently reversed,
- Downgrades in the level of assurance (for example, going from an audit to a compilation),
- Suspicious changes in managers' standards of living, lifestyles or personal behaviors,
- Significant related-party transactions, and
- The use of special purpose entities and unnecessarily complex business arrangements.

Some companies may also misstate financial results to minimize their payouts in lawsuits. For example, a business that's been ordered by a court to purchase a deceased owner's interest pursuant to a buy-sell agreement might downplay year-end results to lower the buyout price.

## Prevent errors

Accounting software, tax regulations and Generally Accepted Accounting Principles (GAAP) are constantly evolving. To minimize misstatements caused by *inadvertent* errors, in-house accounting personnel must stay atop the latest updates. Sometimes the company's CPA can explain what's changed. In other situations, in-house personnel may need to attend outside classes or subscribe to accounting journals — and their employers should provide these resources.

In addition to training, businesses should periodically evaluate staffing in their accounting department. As a company grows, its needs for more-sophisticated expertise grows, and the business should consider expanding this department. For example, as a business matures, an experienced CFO may be needed to supplement the skills of the part-time bookkeeper.

## Safeguard against fraud

To minimize the risk of *intentional* financial misstatements, businesses should conduct annual fraud risk assessments to identify key vulnerabilities or stress points. Once identified, these high-risk areas can be targeted with stronger internal control procedures. Often fraud risk assessments uncover small, but questionable, activities before they become significant problems.

It's also important for businesses to set an ethical tone from the top of the organization. Formal ethics policies and programs can help remind managers and other employees that dishonest behaviors will lead to adverse consequences, such as termination and criminal charges.

## Let's work together

Attorneys are often more realistic about the risk of financial misstatement than business owners. As you work with clients, you may recognize the need to consult a forensic accounting professional to investigate suspicions of misstatement or to implement (or upgrade) preventive measures. ■

*Wayne L. Ryan Revocable Trust v. Ryan*

# Beware of "downward bias" in buyout cases

In shareholder disputes, a company (or the other shareholders) may elect to buy back shares of dissenting or oppressed shareholders to avoid corporate dissolution. The underlying consideration when courts evaluate the buyout price is *fairness*.

In other words, the objective is to determine "the actual worth of that which the shareholder loses." In most states, the appropriate standard of value is "fair value." This standard is typically based on the minority owner's pro rata share of the entire company's value on a controlling basis *before* discounts for lack of control and marketability.

In a recent buyout case, the Nebraska Supreme Court affirmed a district court's finding that the "downward bias" of the company's expert rendered his conclusion "inherently unreliable." This resulted in a substantial award for the plaintiff.

## Same methods, divergent conclusions

The case involved a private family business that operated as an S corporation in Nebraska. The company was founded in 1971 and has since become a worldwide industry leader in medical diagnostics with dozens of patents and annual sales of hundreds of millions of dollars.

After the CEO unsuccessfully attempted to sell the company to an outside buyer, the company's founder sued for shareholder oppression and breach of fiduciary duty. The corporation elected to purchase his shares pursuant to Nebraska law, which led to a valuation proceeding in the District Court of Nebraska for Sarpy County.

Experts for both sides used the discounted cash flow method, along with the guideline public company and merger and acquisition (M&A) methods, to compute fair value.

The court found that analysis performed by the company's expert was "misleading and not credible." Notably, he "double-counted" the same risks when projecting income and factoring company-specific risk into his discount rate. The expert also applied a downward bias when evaluating guideline stocks and M&A transactions and arbitrarily "halving" the opposing expert's S corporation premium.

## Reasonableness prevails

The district court dismissed the company's expert testimony, and ultimately accepted the opposing expert's fair value of $467 million for the shareholder's interest. The court also awarded about $250 million in prejudgment interest.

The company appealed, and the case ended up in the state supreme court. That court, however, affirmed the district court's judgment.

## Proceed with caution

This case is a powerful reminder of the potential costs of unreasonable valuations. When estimating fair value, a trial court can decide to discard one expert's conclusions and adopt the opposing expert's conclusions in their entirety — if they're supported by credible evidence and critically evaluated by the judge. ■

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