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LITIGATION SUPPORT

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IRS sheds light on subsequent events and recycled valuation reports

A recent IRS Chief Counsel Advice (CCA) memorandum offers valuable insight into the IRS's perspective on whether subsequent events may be considered when estimating the fair market value (FMV) of a private business interest for gift tax purposes. The memorandum — which can't be used or cited as legal precedent — also addresses the issue of re-using previously issued valuations for gift and estate tax purposes.

Timeline of events

When reviewing CCA 202152018, it's important to understand the timing of certain key events. The donor (the owner of a "highly successful" company) obtained a valuation for nonqualified deferred compensation issued at year end under Section 409A. About six months later, he re-used the company's 409A valuation when transferring shares to a grantor retained annuity trust (GRAT). Under the terms of the GRAT, the trustee was to base the amount of the annuity payment on a fixed percentage of the initial FMV of the trust property.

Prior to funding the GRAT, the company had been actively soliciting strategic buyers to purchase a minority interest in the business with a call option after several years to acquire the remaining stock at a formula valuation. However, this fact wasn't disclosed in the 409A valuation that was used to determine FMV for the transfer to the GRAT.

> As of the GRAT funding date, it was "knowable" that the company was looking for strategic buyers.

Seven months after the effective date of the 409A valuation and three days prior to the transfer to the GRAT, the company received five offers from prospective third-party buyers. This effectively resulted in a bidding war. Three months after the transfers to the GRAT, the company received another round of offers. Shortly thereafter, the donor gifted company shares to a separate charitable remainder trust. Those gifts were based on the tender offer that was later accepted. The final offer was approximately 10% higher than the offers that were received before the GRAT was funded — and nearly three times greater than the FMV per share under the 409A valuation.

Approximately six months after the end of the GRAT's two-year term, the buyer exercised its option to purchase the balance of the company's shares. It paid a price almost four times the FMV reported in the initial 409A valuation.

Subsequent events

The CCA memorandum noted that the donor had

Subsequent events: What counts?

Timing is critical when valuing a business. Business valuation professionals usually don't factor into their analyses subsequent events that occur *after* the valuation date. But there are two important exceptions:

1. When an event is foreseeable. Under the definition of fair market value, hypothetical willing buyers and sellers are presumed to have reasonable knowledge of relevant facts affecting the value of a business interest. Examples of potentially relevant subsequent events are an offer to purchase the business, a bankruptcy filing, a natural disaster and the loss of a key person. However, not all of these examples would be reasonably *foreseeable*. For example, you probably can't predict when your company will be affected by a tornado or a data breach.

In addition to facts that are publicly available, "reasonable knowledge" includes facts that a buyer would uncover over the course of private negotiations over the property's purchase price. During normal due diligence procedures, a hypothetical buyer is expected to ask the hypothetical seller for information that's not publicly available.

2. When a transaction provides an indication of value. A subsequent event that's unforeseeable as of the effective date may still be considered if it provides an indication of value. However, it generally must be within a reasonable period and occur at arm's length. It's important to differentiate subsequent events that *affect* value from those that provide an *indication* of value.

made several mistakes. Most notably, it didn't account for events that were reasonably known (or knowable) as of the valuation date. (See "Subsequent events: What counts?" above.)

As of the GRAT funding date, it was "knowable" that the company was looking for strategic buyers — and that several prospective buyers had already shown interest in purchasing shares. However, the final price and terms of the sale weren't known until several months after the shares were transferred to the GRAT.

Additional errors

The CCA memorandum also concluded that the company had erred by repurposing an outdated report to value the transfer to the GRAT. When asked to explain, the practitioner stated that the valuation was "only six months old, and business operations had not materially changed during the 6-month period." However, both the passage of time and the arm's-length offers could have had a significant impact on the FMV of the shares and, therefore, should have been factored into the valuation.

Moreover, the memorandum found that the company was inconsistent across tax reporting. After the GRAT was formed, charitable gifts were made using significantly higher valuations that were based on the final purchase price. Using a higher value benefited the donor by providing a higher charitable contribution deduction.

In addition, the valuation prepared for a nonqualified deferred compensation plan wasn't appropriate for gift tax purposes. 409A valuations are used for income tax purposes and typically have less stringent requirements. 409A valuations also won't meet adequate disclosure regulations for estate planning and may value a different class of equity.

Get it right

It pays to keep tabs on guidance issued by the IRS, even if it can't be cited as legal precedent. Here, the donor and his company made several mistakes that teach valuable lessons to others in similar situations. A trusted financial advisor can help navigate the ins and outs of gifting business stock and ensure that the valuation angle is handled properly. ■

Estate of Levine

Taxpayer wins on value of split-dollar arrangement

The U.S. Tax Court recently rejected the IRS's attempt to essentially triple the value of a split-dollar life insurance arrangement in a decedent's taxable estate. *Estate of Levine* demonstrates the importance of careful drafting in estate plans.

The issue

IRS regulations broadly define a split-dollar insurance arrangement as an agreement between an owner and nonowner of a life insurance contract where:

- Either party directly or indirectly pays all or part of the premiums,
- The party paying is entitled to recover all or part of the payments, with repayment made from, or secured by, the insurance proceeds, and
- The arrangement isn't part of a group term life insurance plan that doesn't provide permanent benefits.

The goal generally is to remove the insurance policy from a taxable estate and allow the proceeds to go to the beneficiaries tax-free.

Case specifics

In *Levine*, an irrevocable insurance trust was created to purchase insurance policies on the decedent's daughter and her husband. The decedent's revocable trust paid the premiums, and the insurance trust agreed to assign the insurance policies to the revocable trust as collateral.

The insurance trust also agreed to pay the revocable trust the greater of the total premiums paid ($6.5 million) or either:

1. The current cash surrender values of the policies upon the death of the last surviving insured, or
2. The cash surrender values of the policies on the date they were terminated, if terminated before both insureds died.

Only the insurance trust's trustee had the right to terminate the policies.

The decedent died before her daughter and son-in-law. Her estate tax return included about $2 million for the value of the split-dollar receivable (her right to payment from the insurance trust).

The IRS noticed the transfer of money from the revocable trust for the purchase of life insurance policies benefiting the insurance trust and launched an audit. It determined that the estate should have included the $6.2 million cash surrender value of the policies. The estate turned to the Tax Court for relief.

Failed IRS argument

The IRS argued that, under IRC Sections 2036 and 2038, the decedent was the owner of the policies, so the cash surrender value was part of her estate. Sec. 2036 generally prevents taxpayers from avoiding estate tax liability by transferring assets in which they retain an interest or right. Sec. 2038 claws back into an estate the value of transferred property in which the decedent retains an interest or right to alter, amend, revoke or terminate the transferee's enjoyment of the property.

The court found that neither provision applied because, at the time of her death, the decedent held only the right to the receivable. She had no right to terminate the policies — only the trustee had that right. Without a contractual right to terminate, she didn't have any possession of or right to their cash surrender values.

A potential roadmap

The Tax Court's ruling provides a valuable example of how properly structured split-dollar arrangements can survive IRS scrutiny and produce significant tax savings. Contact your financial advisor to help with these and other estate planning strategies. ■

Detecting fraud with proactive measures

Each year, businesses lose about 5% of revenue to fraud, according to *Occupational Fraud 2022: A Report to the Nations*. A key takeaway from the biennial report published by the Association of Certified Fraud Examiners (ACFE) is that *active* detection methods are far more effective than passive methods in reducing fraud loss and duration. Unfortunately, many companies fail to use these methods to their full potential.

How do active and passive detection methods differ?

The best way to minimize fraud losses and the duration of fraud scams is to implement antifraud controls to actively detect schemes, rather than waiting to be notified by police or receive confessions. The ACFE study found that frauds detected using passive methods — where incidents came to the victims' attention through no effort of their own — tend to last longer and produce larger losses than those detected by active methods. Examples of effective antifraud controls include data monitoring and analysis, account reconciliation, internal and surprise audits, and management review.

Active methods of detection can significantly lower fraud durations and losses. For example, frauds detected by account reconciliation had a median

duration of eight months and a median loss of $74,000. By comparison, fraud detected through notification by police had a median duration of 18 months and a median loss of $500,000.

Job rotation, mandatory vacation policies and surprise audits can be especially effective ways to fight fraud. On average, these proactive measures cut median losses and durations in half. Yet only 25% of the organizations in the ACFE study had job rotation or mandatory vacation policies in place — and just 42% had implemented surprise audits. These findings suggest that many organizations have an opportunity to add these highly effective, low-cost tools to their antifraud arsenal.

Are tips considered active or passive?

The ACFE categorized tips — the leading fraud detection method — as "potentially active or passive," because they may or may not involve proactive efforts designed to identify fraud. Organizations that proactively use hotlines for reporting misconduct detected fraud by tips more often (47% of cases) than those without hotlines (31% of cases).

More than half of tips came from employees, but nearly one-third came from outside parties, such as customers and vendors. To ensure that tips are used as an active detection method, an organization should set up a hotline, provide training, and promote its use among employees, supply chain partners and others. If possible, hotline users should be able to make anonymous reports. It's also noteworthy that online and email reporting mechanisms tend to be more prevalent today than telephone hotlines.

What other statistics did the report reveal?

Here are more key findings from the ACFE's 2022 study. These statistics underscore the importance of taking steps to detect fraud proactively rather than passively.

- Asset misappropriation occurred in 86% of cases. It was the most common but least costly type of occupational fraud, with a median loss of $100,000.
- Financial statement fraud occurred in 9% of cases. It was the least common but costliest type of occupational fraud, with a median loss of $593,000.
- Corruption, such as bribery or conflicts of interest, occurred in half of cases. It caused a median loss of $150,000.
- Small businesses with fewer than 100 employees lost 50% more per fraud scheme ($150,000 median loss) than larger businesses ($100,000 median loss). In general, small businesses have fewer resources to implement robust antifraud controls.

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Occupational fraud victims that attempt to recover losses from perpetrators are rarely made whole. According to the ACFE survey, 54% of victims in the United States recovered nothing, 33% made a partial recovery and only 13% fully recovered their losses. The bigger the loss, the less likely the victim was to make a full recovery.

To catch a thief

Organizations that implement active antifraud controls can dramatically reduce their losses. In addition to investigating suspicious behaviors, a forensic accounting expert can evaluate a company's controls, identify potential weaknesses and recommend ways to lower risks — before fraud strikes. ■

How do value conclusions and value calculations differ?

The value of a business is relevant in a wide variety of legal contexts, including divorces, shareholder disputes, mergers, bankruptcy and tax planning. Not every so-called "valuation" service is the same, however. It's important to understand the different services valuators offer so you can make an informed choice.

Comparing engagements

The American Institute of Certified Public Accountants (AICPA) recognizes the following two valuation engagements:

1. Conclusions of value. Here, valuators consider all approaches and procedures they find appropriate for the circumstances. The valuation will take into account applicable valuation practices and standards, as well any relevant legal precedents. The result may be presented as a single amount or a range of values.

2. Calculations of value. This level of service is more "bare bones" than a full-blown valuation. For a calculation of value, the expert generally applies only approaches and procedures the client explicitly agrees to in advance. The result is expressed as a calculated value that may be a single amount or a range of values.

A calculation typically includes a disclaimer stating that the result could have been different if a full valuation had been performed. Beware: When calculations are presented in a litigation setting, this admission may raise a red flag to opposing counsel and discredit the expert's conclusion in the eyes of the court.

The professional standards of other valuation organizations, such as the National Association of Certified Valuation Analysts (NACVA) and the American Society of Appraisers (ASA), provide similar guidance.

Selecting the right service level

A full-blown valuation generally produces a comprehensive, reliable estimate. But a calculation can be a cost-effective tool under the right circumstances. For example, a valuator might decline a valuation engagement because the requisite information isn't available. In addition, a calculation could be appropriate for clients who are negotiating the sale of a business or settling a lawsuit. They also may be appropriate for initial estate and tax planning.

On the other hand, a full-blown valuation is often required for IRS issues, such as estate and gift tax filings, as well as other valuation engagements, including valuations prepared for Small Business Administration programs. They're also generally advisable when litigation is involved, as courts tend to find them more credible than calculations.

Look before you leap

When valuing a business, one size doesn't necessarily fit all clients. Before hiring an expert, discuss the intended uses, access to the company's financial records, and time and resource constraints to determine what's appropriate for your situation. ■

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