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LITIGATION SUPPORT

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Glade Creek Partners, LLC v. Commissioner

"Single-minded" pursuit of tax objective in appraisal triggers penalty

A recent ruling from the U.S. Court of Appeals for the 11th Circuit illustrates the importance of objective valuations obtained in good faith. Objectivity is particularly critical when trying to support significant tax claims. In the appellate court case, the taxpayer's dogged pursuit of tax objectives ultimately led to the IRS imposing a 20% accuracy-related penalty.

Disputed deduction

The case involved a limited liability company (LLC) that made a conservation easement donation. The easement covered 1,313 acres of undeveloped property that was part of a failed residential development. The LLC acquired the land in a transaction intended to spare the developers from the debt associated with the failed development.

The LLC claimed a $17.5 million charitable contribution deduction for the year of the donation. The IRS denied it, because the deed of easement didn't protect the conservation purposes in perpetuity, as required by tax law. The IRS also assessed a "substantial valuation misstatement" penalty of 20% of the resulting tax underpayment. This penalty generally applies when a taxpayer has misstated the value of donated property by 150% to 200% of the property's fair market value (FMV).

> Courts allow tax deductions only when appraisals are based primarily on the economic realities of a transaction.

Tax Court decision

The LLC unsuccessfully sought relief from the U.S. Tax Court. The court agreed with the IRS that the easement didn't satisfy the "in perpetuity" requirement, so the LLC wasn't entitled to a deduction. The court then found that the easement's FMV was about $8.9 million, meaning the LLC had overvalued the easement by more than 150%, but less than 200%. Thus, the substantial valuation misstatement penalty was appropriate.

The court also held that the reasonable cause exception to the penalty didn't apply. Under this exception, a taxpayer can avoid the misstatement penalty if "the claimed value of the property was based on a

Tax Court's second go-around

After the 11th Circuit Court remanded *Glade Creek* back to the U.S. Tax Court (see main article), the IRS conceded that the limited liability company (LLC) was entitled to a conservation easement deduction. As a result, the court had to decide only whether the LLC was entitled to deduct the easement's fair market value (FMV) or just the LLC's adjusted basis in the property on which the easement was granted. The answer came down to whether the property was inventory or investment property in the hands of the LLC partner that contributed the property.

The LLC partner reported on its tax return that it was in business as a real estate dealer. It also reported the easement property as inventory and reduced the amount of its inventory on the transfer of the property to the LLC. So, the court concluded that the easement property was inventory primarily held for sale to customers. As such, the LLC's deduction was only about $3.7 million, compared to the FMV of nearly $8.9 million.

qualified appraisal made by a qualified appraiser," and the "taxpayer made a good faith investigation of the value of the contributed property."

The LLC's appraisers used the "before-and-after" method to value the easement, the standard method for valuing such subjects. However, the court found that the appraisers determined the "before" value to achieve the tax savings goals of the easement transaction and didn't try to accurately ascertain the easement's FMV. It also found the LLC's manager didn't make a good faith investigation into the FMV or rely on the appraisers in good faith. Rather, he knew the easement was substantially overvalued.

Mixed bag on appeal

The LLC appealed to the 11th Circuit, where it had more luck. The appellate court found that the tax regulation the Tax Court relied on when rejecting the easement was invalid. Therefore, it vacated the denial of the deduction. It remanded that portion of the case to the Tax Court for further consideration without reliance on the regulation. (See "Tax Court's second go-around" above.)

But the 11th Circuit affirmed the FMV of the easement property and, in turn, the substantial valuation misstatement penalty. It found "plenty of evidence" to support the determination that the easement's value was less than that calculated by the LLC's appraisers in support of the deduction. In fact, the court pointed out, the appraisal report supported the Tax Court's valuation of the easement, which was based on the same data and applied the before-and-after valuation method.

Next, the appellate court considered whether the reasonable cause exception applied. It noted that the LLC admitted that its manager understood the intent of the easement was to raise enough money to repay the outstanding debt and preserve the property. And he clearly wanted an appraisal that accomplished his tax objectives. "By pursuing that goal single-mindedly," the court found, he didn't obtain the appraisal in good faith.

Even if he had, the exception also requires a good faith investigation into the property's value. The LLC presented no evidence showing the manager made such an investigation beyond obtaining the appraisals. Courts allow tax deductions only when appraisals are based primarily on the economic realities of a transaction rather than the tax motives.

Lesson learned

Although the LLC may have secured a charitable deduction, the deduction was a fraction of the intended amount. Moreover, the LLC incurred substantial litigation costs and a hefty penalty. It's important for clients to recognize working backwards to accomplish specific tax objectives may leave them vulnerable to similar outcomes. ■

Beware: Do-it-yourself M&A due diligence can be perilous

Merger and acquisition (M&A) advisors are generally optimistic about current market conditions. Many anticipate that stable or lower interest rates, technology innovations, and stabilized or reduced inflation will trigger increased M&A volume in 2024. Whether you're buying, selling or merging, it's important to "vet" the deal before closing. A financial professional can help conduct comprehensive due diligence during the dealmaking process.

Buyer concerns

Many business combinations ultimately fail to increase shareholder value. But thorough due diligence can help buyers beat the odds. The extent of due diligence a buyer performs will be determined, in part, by the type of sale.

Asset sales may be advantageous, because buyers generally are responsible for only the liabilities expressly assumed and those secured by the purchased assets. Conversely, a buyer in a *stock* sale generally assumes all liabilities, including undisclosed and contingent obligations. Buyers must be vigilant when reviewing financial statements, as well as hard assets, facilities, real estate and legal agreements. There are also tax implications to consider that vary depending on how a deal is structured.

Targeted procedures

Due diligence findings can educate the buyer about the target company's financials and operations and reveal possible stumbling blocks. Common due diligence problem areas include:

Contracts. It's important to determine the assignability of key contracts. Examples include franchise agreements, vendor contracts, insurance policies, and equipment or property leases. Contracts that can't be assigned to a new owner may present risks to continuing business operations.

Internal control weaknesses. Buyers should investigate whether the target has a solid system of controls in place. Inadequate controls — such as lax management oversight, a lack of segregation of duties and weak cybersecurity protocols — could put a buyer at risk for financial reporting errors and fraud.

Unreliable asset values. Buyers can't take key balance sheet items, such as accounts receivable and inventory, at face value. They need to dig deeper to assess whether bad debts and old, obsolete or damaged goods are on the books.

Off-balance-sheet items. When buying stock in a business, the existence of unreported items — such as undisclosed property liens, ongoing litigation, golden parachute clauses and environmental violations — could lead to unpleasant surprises after closing.

Tax issues. Tax liabilities, evasive practices, and audits related to income, sales, payroll and property taxes may become the buyer's responsibility in a stock sale.

Independent earnings projections

In addition, prospective buyers should perform independent, market-based projections of future earnings and cash flows, rather than rely on the seller's representations and estimates. Sellers may be overly

optimistic when preparing projections, especially when anticipating future sales. Any discrepancies between the buyer's and seller's expectations should be reconciled to find the underlying cause.

Problems or material misrepresentations may warrant a lower offer price or renegotiated terms. Sometimes, it's in the buyer's best interest to walk away from a deal.

Seller concerns

Some people think M&A due diligence is just the buyer's responsibility, but sellers may have concerns, too. In addition to helping set a reasonable asking price, financial professionals can help sellers compile prospectus packets, evaluate deal structures and screen prospective buyers.

Sell-side due diligence often targets the financial health of potential buyers to prevent fraud and deal-ending financing shortfalls. Some buyers may be willing, but not financially able, to acquire a business. If a buyer doesn't qualify for a conventional loan, the seller might be asked to finance at least part of the deal. Seller-financed loans or deal structures that involve installment payments generally are tied to how well the buyer runs the acquired business.

Financial professionals can analyze the buyer's financial statements, business plans, credit history and public records (including performing background checks on the company's principals). This information can help a seller assess whether the company will make good on a loan or installment plan.

Navigating a successful deal

Do-it-yourself M&A due diligence can lead to undesirable outcomes and unexpected surprises. Consulting financial and legal professionals early in the negotiation process saves buyers and sellers money and stress over the long run. ■

Assembling a forensic accounting team to investigate fraud claims

Fraud schemes are becoming more complicated and sophisticated, so it's vital to build an effective forensic accounting team to investigate suspicious activity. Unfortunately, fraud teams often are assembled hastily and with little thought to their composition. Here are some tips to help you develop a group that can cover all the bases and avoid costly mistakes.

Use a multidisciplinary approach

All forensic accounting team members should be free of conflicts and bring qualifications that are relevant to the specific investigation. For instance, if management suspects an employee of accepting kickbacks, the team should include accountants who have experience examining such schemes — as opposed to experts who merely have a theoretical understanding of the matter. Similarly, if the scheme is particular to a certain industry, such as inventory theft in a pharmaceuticals manufacturing business, the team should include someone with experience in that sector.

At least one team member should be familiar with issues related to potential litigation, such as discovery and expert testimony. Most investigations today also require electronic evidence expertise, including knowledge of data mining, extraction and preservation.

Additionally, because most investigations conclude with a final written report, the team should include someone with report-writing skills. In many cases,

intermediate reports also are drafted throughout the investigation process.

Screen squad members

An auditing background usually isn't sufficient to prepare someone to conduct fraud investigations. Although it provides a strong foundation, certified public accountants (CPAs) investigating fraud incidents also need specific forensic skills.

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The nonattest services standards of the American Institute of Certified Public Accountants (AICPA) explain that providing a client with specific forensic services may impair a CPA's independence for audit and other attest service purposes. The AICPA standards don't specifically *prohibit* forensic services from an accounting professional who performs attest services (including audits) for a client.

However, enlisting this expert for a fraud team could call into question his or her adherence to professional standards, which could, in turn, undermine the expert's credibility. Ideally, team members hold no such risk and are able, when necessary, to challenge your and your clients' perspectives.

Some CPAs pursue specialized undergraduate or master's degrees in forensic accounting. Others obtain the certified fraud examiner (CFE) designation awarded by the Association of Certified Fraud Examiners (ACFE), the world's largest professional antifraud training and education organization. The ACFE requires education and work experience, plus successful completion of a comprehensive exam that covers 1) financial transactions and fraud schemes, 2) law, 3) investigation, and 4) fraud prevention and deterrence. To maintain the CFE credential, an expert also must abide by the ACFE's bylaws and code of professional ethics.

Assemble your team

Forethought and attention to detail are critical when putting together a team of experts to investigate potential fraud incidents. Your CPA can be a helpful resource during this stressful time. This trusted advisor — if not trained in forensic accounting — can refer you to other specialists to help ensure you avoid data preservation and legal minefields. ■

How appraisers value noncompete agreements

The value of a noncompete agreement with a business's former owner or key employee may be relevant in multiple contexts, including mergers, financial reporting and tax matters. Let's answer some critical questions that may arise in the process of valuing noncompetes.

How are noncompetes valued?

Noncompete agreements provide business owners with protection from reduced profits due to competition from the other party to the agreement. The most common approach for valuing a noncompete is the "with-and-without" method (also known as the "lost income" method). It's based on the cash flows the business might lose if the restricted party competes against it — in other words, the cash flows "with and without" the noncompete.

Generally, the first step is determining the present value of the business's cash flows *without* the restricted party's competition. Then the valuator compares this figure with the present value of the cash flows *with* such competition. The determination of the present value in the case of competition requires consideration of factors such as the estimated effects on sales, profit margins, working capital and capital expenditures. Another critical factor is the restricted party's likelihood of successful competition. Here, a valuator multiplies the present value of the difference between cash flows with and without competition by the probability of successful competition.

Factors relevant to the probability include whether the restricted party is willing to compete against the business and is capable of doing so. This may depend on such factors as:

- The person's age, health, financial standing and relationships with customers,
- The business's competitive position in the market,
- Economic trends, and
- Barriers to entry.

Finally, to reach a value for the noncompete agreement, a valuator will add the present value of the income tax savings the business will reap from amortizing a noncompete agreement as an intangible asset for tax purposes.

Is the noncompete enforceable?

A noncompete's value is based on the assumption that the agreement is valid. This generally means that it's reasonably tailored to protect legitimate business interests. For example, a court might reject an agreement that covers an unreasonably large geographic area or time period. Also, some state ban noncompetes altogether.

In addition, the U.S. Federal Trade Commission recently approved a rule that will prohibit employers from imposing noncompetes on most *employees*. But a noncompete will remain permissible when the prior owner won't stay with the business under the purchase agreement. The rule could have a major impact on the value of noncompetes going forward and is scheduled to go into effect in August 2024. As of this writing, business groups had filed suit against the rule, which could delay implementation or overturn the rule. ■

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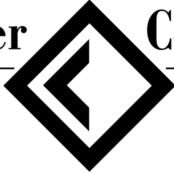

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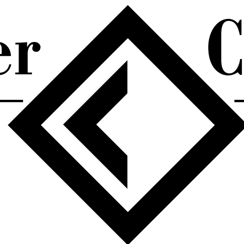

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