

The Expert

SPRING 2011

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Need a fruitful idea for your estate plan?

Conditions are ripe for an FLP

Despite speculation by financial and legal pundits that their days were numbered, family limited partnerships (FLPs) survived the latest wave of estate tax legislation quite handily. In fact, for those managing estate plans, conditions are ripe to seriously consider an FLP once again.

Nuts and bolts

Here's how one works: A senior family member contributes assets, such as marketable securities, real estate and private business interests, to a limited partnership. In turn, he or she receives general and limited partner interests, which may be "gifted" to family members and charitable organizations. Limited partners can't control day-to-day activities and, therefore, their units tend to be worth less than general partner units.

Individuals who set up an FLP or gift interests in an existing FLP now can potentially transfer a substantial portion of their estate to heirs without incurring gift tax.

Other partners (typically children and grandchildren) also may make capital contributions to the partnership in return for general or limited partner interests. Or they may receive general or limited units as gifts from senior family members. Partner rights, which typically limit who can buy and sell partner units, are governed by an FLP agreement.

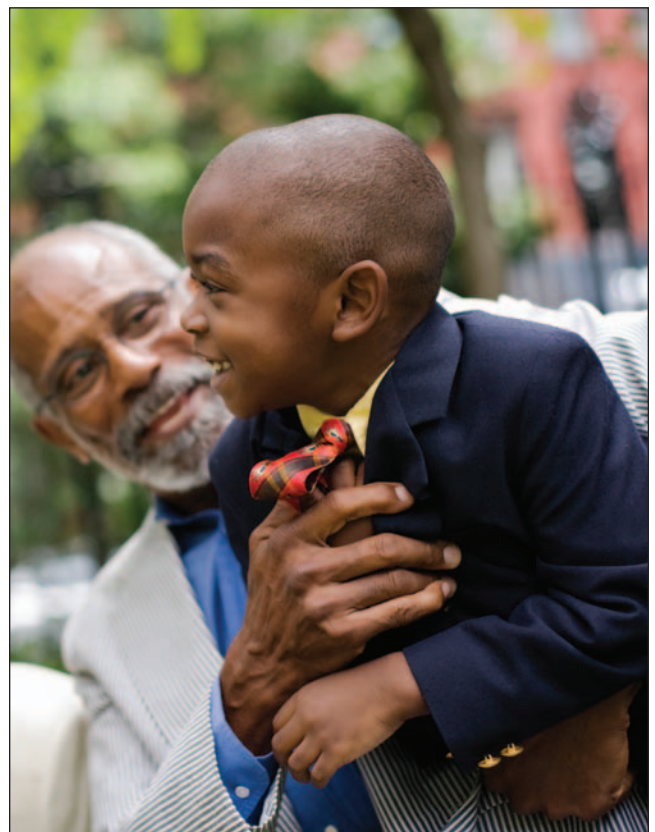
An FLP must be established for a legitimate business purpose, such as efficient asset management and protection from creditors. Partnerships set up exclusively to minimize gift and estate taxes won't pass IRS muster.

Valuation issues

Independent asset appraisal is key to executing an effective FLP. Without appraisals, donors can't accurately determine the number of partner units to allocate when making gifts. And the IRS will likely attack any gift of FLP units based on a do-it-yourself appraisal.

Appraisers begin by determining the partnership's net asset value, which is the combined fair market value of its assets on a controlling, marketable basis minus any liabilities. The value of marketable securities can be obtained from sources such as brokerage statements or the *Wall Street Journal*.

A real estate appraiser will value real property, while a business appraiser determines the value of private business interests.



How discounts apply

Business appraisers frequently apply discounts for lack of control and marketability to any limited partner interest, regardless of the FLP's underlying assets. Often these discounts may be substantial and separate from discounts taken at the net asset level, potentially reducing the net asset value by 40% or more. The magnitude of discounts varies depending on numerous factors, such as:

- ◆ The nature and composition of the partnership's underlying assets,
- ◆ Partnership agreement rights and restrictions,
- ◆ State laws,
- ◆ Current market conditions,
- ◆ Historic and projected income distributions,
- ◆ Relevant legal precedent, and
- ◆ The rate of return that an investor would expect given overall risk associated with the subject interest.

General partners manage all aspects of partnership operations, including cash distributions, asset sales and acquisitions, and partnership dissolution. Because limited partners (by state law) lack control over partnership affairs, the interests are at an economic disadvantage, which typically warrants a discount for lack of control from net asset value.

Limited partner units also lack a ready market on which they may be sold. This reduces or discounts their value and makes them less valuable to a potential investor. Lack of marketability may further reduce value if the partnership agreement restricts transfers to people outside the family.

Marketability discounts are taken after discounts for lack of control. This is important because the two discounts are multiplicative, not additive. In other words, a 20% discount for lack of control and a 30% discount for lack of marketability equal a combined discount of 44%, not 50%.

Abusive practices

A family limited partnership (FLP) can be an effective way to transfer wealth that withstands IRS scrutiny — if properly structured and carefully administered. But an FLP may crumble under scrutiny if general partners engage in abusive business practices.

Examples of potential pitfalls include partnerships established on a senior family member's deathbed and general partners who contribute substantially all of their personal assets to the FLP. The IRS also has achieved success against donors who claim excessive, unsupported valuation discounts.

Why the time is right

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 retroactively reinstated the estate tax for that year.

Through the end of 2012, it raised the lifetime estate tax exemption to \$5 million (from \$3.5 million in 2009) while lowering the estate tax rate to 35% (from 45% in 2009). Additionally, if one spouse dies in 2011 or 2012, the act's portability provision allows the other spouse to reclaim any unused portion of the deceased's \$5 million lifetime exemption.

But here's the hitch: The estate tax breaks are only in effect until the end of 2012. Unless Congress extends the \$5 million exemption, the 35% tax rate and the portability provision, everything will return to pre-2001 levels thereafter.

Thus, individuals who set up an FLP or gift interests in an existing FLP now — while asset values may be at historic lows and estate tax laws are relatively generous — can potentially transfer a substantial portion of their estate to heirs without incurring gift tax.

Line of defense

With estate tax matters settled for a little while, now's a good time to look into using an FLP to transfer wealth to future generations or charities. But an independent appraiser's help is essential to establishing an effective line of defense against IRS scrutiny. ◆

Employee stock options present valuation challenges

There was a time when employee stock options (ESOs) were all the rage. Companies of almost any size were handing them out to entice and retain the best and brightest job candidates on the market. And the idea of having the right, though not the obligation, to buy stock shares at a fixed (“exercise”) price within a stated period (usually 3 to 10 years) held a substantial amount of cachet with employees.

Recently, however, the recession and its aftermath have caused many businesses to think twice about the benefit. Yet it hasn’t fallen out of favor entirely. If your company is one of those still offering ESOs, it’s more important than ever to get them properly valued. And appraisers face distinctive challenges in doing so.

The important inputs

Accounting for ESOs became more complicated when the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*. This rule eliminated the intrinsic method of reporting ESOs, which typically deferred expense recognition until employees exercised their options.

Now companies that issue ESOs must use the fair value method, which recognizes salary expense over the requisite service period (typically, the vesting period) at the option’s fair value. The value of an ESO is frequently determined based on six basic inputs. These include exercise price, current stock price and the expected volatility of that stock price. Other important inputs: expected life (or maturity) of the option, expected dividends from the company’s stock and the expected risk-free rate over the option’s life.

Many of these inputs, including exercise price and duration, are fairly straightforward. But the value of private companies isn’t readily available, requiring issuers to enlist valuation expertise.

Models for valuation

The first step in valuing private ESOs is to appraise the business. The appraiser then allocates business value among common stock, ESOs and other equity instruments (if applicable). FASB generally recommends a couple of different models for valuation.

First, an appraiser may opt for the “closed form.” The most common, the Black-Scholes Option Pricing Model, was created in 1973 to value publicly traded European stock options, which can only be exercised on the maturity date. Black-Scholes is easy to use, but its underlying mathematics is based on calculus, which is difficult to explain to laypeople. It also can be inflexible, especially when it comes to valuing private stock options that contain, for example, vesting or early exercise clauses.

As an alternative, an appraiser may choose the “lattice” model. For publicly traded options, closed form and lattice models will usually generate identical values. But private ESOs differ from publicly traded options in many ways. For example, they usually have longer maturities and may contain vesting, forfeiture, and change-in-control provisions.

Companies that issue ESOs must use the fair value method, which recognizes salary expense over the requisite service period (typically, the vesting period) at the option’s fair value.

Appraisers use lattice models to account for these (and other) differences. Lattice models employ basic algebra and organize the valuation methodology in a logical decision tree format, which is easier for nonfinancial people to understand.

Accurate allocations

Another key difference between public and private company options is that publicly traded stock options don't result in the company issuing new shares of stock. Instead, public transactions occur when third-party call writers transfer existing shares of stock.



But when employees exercise private ESOs, closely held companies typically issue new shares of stock. ESOs dilute the value of existing shares, because employees only exercise options when the exercise price is less than the market price. ESOs, then, affect the price of the company's private stock.

Conversely, the price of common stock is an input in valuing ESOs. This means that allocating business value among equity instruments is an iterative process. Fortunately, valuers can design spreadsheets to arrive at accurate allocations of value.

Not particularly simple

As you can see, estimating the value of ESOs isn't a particularly simple process. For this reason, it's essential to get a professional appraiser involved in doing the math. Although this benefit still has plenty of value for attracting and retaining key employees, it also brings accounting and financial reporting responsibilities for employers. ♦

On the line

Telecom case turns on subsequent sale data

The validity of any business appraisal report depends largely on its use of relevant data before and after the valuation date. The case of *Ringgold Telephone Co. v. Commissioner* hung on one particular subset of relevant data: a subsequent sale of business assets. The Tax Court's decision holds some important lessons.

The "S" election

The petitioner, Ringgold Telephone Co., provides telephone communications services in Georgia and Tennessee. In 2000, Ringgold owned a 25% share in Cellular Radio of Chattanooga (CRC). CRC's primary asset is a 29.54% interest in another wireless telecommunications company called Chattanooga MSA Limited Partnership.

On Jan. 1, 2000, Ringgold elected to be taxed as an S corporation. (Before 2000, Ringgold had been operating as a C corporation.) Internal Revenue Code Section 1374 imposes a corporate-level tax on S corporations that were formerly C corporations if they sell assets within 10 years of the conversion date. A CPA valued Ringgold's interest in CRC at \$2.6 million on the conversion date.

Ringgold sold its interest in CRC to one of its three equal partners (BellSouth) in November 2000 for \$5.2 million. On its 2000 federal tax return, Ringgold reported built-in capital gains from the sale of its CRC interest using the CPA's value of \$2.6 million on the conversion date.

In August 2007, Ringgold received a deficiency notice from the IRS, claiming the CRC interest was worth \$5.2 million (the November 2000 selling price) on the conversion date.

Valuation methods

After receiving the deficiency notice, Ringgold hired another CPA with a business valuation designation who had significant experience in valuing telecom firms. He valued Ringgold's interest using the capitalization of income, discounted cash flow, guideline public company and guideline M&A methods.

He also considered the company's actual dividend-paying history, which the Tax Court opined was relevant when valuing minority interests. After taking a modest 5% marketability discount, the taxpayer's expert concluded that the CRC interest was worth \$2.98 million on Jan. 1, 2000.

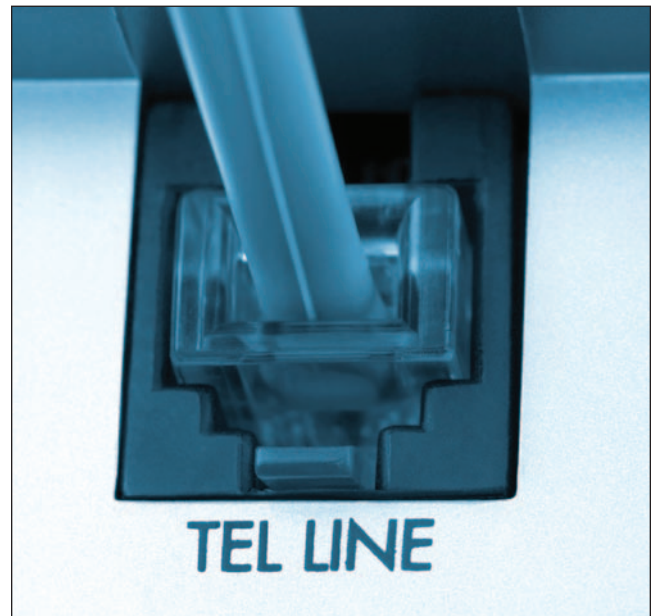
The IRS hired a CPA who had recently returned to business valuation and had never appraised a telecom firm. He averaged the results of his discounted cash flow and guideline M&A methods and applied a 35% marketability discount. His "more mechanical approach" generated a value of \$5.155 million for the CRC interest.

The petitioner in this case elected to be taxed as an S corporation. Internal Revenue Code Section 1374 imposes a corporate-level tax on S corporations that were formerly C corporations if they sell assets within 10 years of the conversion date.

The court found Ringgold's expert to be more persuasive and reliable, based on his extensive industry experience. Unlike the IRS's expert, who relied on historic data, the petitioner's expert "[tailored] his analyses to reflect industry conditions on the valuation date."

Subsequent events

Appraisers typically consider information that was "known or knowable" on the valuation date, according to the AICPA's *Statement on Standards for Valuation Services*. But the IRS often considers subsequent sales to be an objective indication of value — especially if the sale occurs within a reasonable time frame between unrelated third parties.



Although the Tax Court preferred the taxpayer's valuation methodology, it concluded that he should have addressed CRC's subsequent sale to BellSouth. But, according to the court, the selling price "should be adjusted to reflect the likelihood that BellSouth viewed the CRC interest as a strategic acquisition and was willing to pay a premium...." The \$5.2 million selling price was "probative but not conclusive" of fair market value.

So, the court assigned the actual sales price a one-third weight and Ringgold's valuation a two-thirds weight to arrive at a value of approximately \$3.7 million for Ringgold's interest in CRC on Jan. 1, 2000.

Difference maker

As *Ringgold* shows, appraisers must pay particular attention to subsequent sales. These transactions can have a significant impact on an estimate of fair market value. The timing, level of value and other intervening circumstances of a subsequent sale could turn out to be a difference maker in court. ♦

ACFE report identifies a variety of red flags

The Association of Certified Fraud Examiners (ACFE) releases its *Report to the Nations on Occupational Fraud and Abuse* every other year, and the results are never pretty. For example, in the 2010 version, survey participants estimated that the typical business worldwide loses 5% of its annual revenues to occupational fraud. Fortunately, the report also identifies a variety of red flags to look out for.

Common warning signs

The ACFE asked 1,843 certified fraud examiners to identify the warning signs that had been displayed by perpetrators in each examiner's single largest fraud case since January 2008. (The survey period extends to December 2009.)

The most common signs were: living beyond financial means (43% of the cases in the study), experiencing financial difficulties (36%), excessive control issues with regard to their jobs / unwillingness to share duties (23%), and an unusually close association with vendors or customers (22%). These results closely shadowed the results of the last survey in 2008.



Position-based red flags

Warning signs that a perpetrator might display can vary by job position. Employee-level perps, for example, are most likely to have financial difficulties. Financial difficulties were also present in frauds committed by managers and owners/executives but significantly less often.

Higher-level perpetrators were much more likely to display control issues, have unusually close associations with vendors or customers, or exhibit a “wheeler-dealer” attitude. The ACFE report theorizes that these signs tend to reflect the greater authority wielded by managers and owner/executives, who are better positioned to influence business decisions, arrange deals with outside parties, and exert control over the company's direction or tone.

Scheme-based red flags

The ACFE report also examined the distribution of red flags based on the type of fraud committed. Perpetrators who committed financial statement frauds were more likely than other perps to exhibit control issues or experience excessive pressure to perform within the organization.

But experiencing financial difficulties and living beyond one's means weren't as common for these fraudsters. This may be because other factors — such as meeting earnings forecasts — could provide as much motivation as personal financial gain.

Living beyond one's means and an unusually close association with a vendor or customer were the most common flags in corruption cases. And a wheeler-dealer attitude was more common in corruption cases than other types of fraud. In misappropriation cases, living beyond one's means and financial difficulties were the two most common red flags.

Indicators inconclusive

It's important to remember that, on their own, these red flags don't prove that an individual is committing fraud. You'll want to bring in a qualified fraud expert to conduct a thorough investigation before jumping to conclusions. ♦