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Summer 2012

IVSC Issues New Guidelines on Fairness Opinions

"A valuation or valuation analysis is often at the core" of a fairness opinion, says the International Valuation Standards Council (IVSC) in a news release. Although some countries regulate the conditions surrounding fairness opinions—including who may provide them and what they should contain—these requirements "are not consistent," the IVSC says, "and many companies are domiciled in countries with no regulation at all." Further, because a typical fairness opinion contains more than valuation advice, they often fall outside of the International Valuation Standards and the related ethical framework.

To bridge this gap and to promote the key principles of "independence, objectivity, and transparency," the IVSC has just issued a new exposure draft of its Procedural Guidelines for Fairness Opinions. Download a copy of the draft at: http://www.ivsc.org/pubs.

9th Circuit Permits Subsequent Events in Valuing Uncertain Claims

Marshall Naify Revocable Trust v. United States, 2012 U.S. App. LEXIS 2925 (Feb. 15, 2012)

Two years before he died, Marshall Naify put in motion a plan to avoid paying California taxes on $660 million in capital gains from the conversion of stock. He formed an out-of-state company to hold the shares in 1999, the year of conversion, so that when he died in 2000, his estate reported no taxable income on his California returns.

When his estate filed its federal tax return, however, it deducted $62 million for the estimated amount that the decedent might owe if his tax avoidance scheme failed. Ultimately, the California taxing authority asserted a claim of $58 million on the $660 million gain. After lengthy negotiations, the parties settled for $26 million.

In the meantime, the Internal Revenue Service (IRS) initially disallowed the estate's $62 million deduction for the estimated claim, but after the California settlement, it permitted a $26 million deduction. The estate paid the resulting $11 million deficiency and then sued for a refund in federal court. In particular, the estate argued that it was entitled to a $41 million deduction, because—based on its expert's evidence—the probability that the decedent's tax plan would fail was 67 percent. The IRS filed a motion for summary judgment, arguing that the estate failed to show that the contingent claim was ascertainable with reasonable certainty. The court granted the motion, limiting the estate's deduction to the $26

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million settlement with California, and the estate appealed.

Expert valuation does not help. The U.S. Court of Appeals for the 9th Circuit began its review by reciting applicable law. Specifically, §2503(a)(3) permits deduction of "enforceable" claims against the estate, including tax obligations, but the Treasury regulations mandate that, to deduct an estimated amount of a claim, the estate must show that it is "ascertainable with reasonable certainty."

In this case, several "post-death" events would have needed to occur for the income tax liability on the $660 million gain to come due, the court explained. Moreover, the estate's expert "did not establish that the estimated amount of the claim was ascertainable with reasonable certainty" at the time of death, the court said.

The expert's report also showed that the decedent's tax avoidance plan had a 67 percent likelihood of failure, "which leads to the inescapable conclusion that his plan also had a 33 percent chance of success," the court said. If his plan had succeeded, then the tax claim might never have been asserted or even paid; if the plan failed, there was "nothing suggesting that the amount of the claim was reasonably certain to be $47 million, as opposed to some other amount."

The law is clear that "post-death events are relevant when computing the deduction to be taken for disputed or contingent claims," the court held, citing 9th Circuit precedent. Subsequent events are irrelevant only when the claims are for sums that are certain and legally enforceable at the time of death.

As a result, the 9th Circuit agreed with the federal district court that the $27 million settlement determined the claim's worth against the estate and dismissed the estate's suit for a refund.

Economy May Be Triggering Litigation in Every Public Deal

"Almost every acquisition of a large U.S. public company announced in 2010 or 2011 elicited multiple lawsuits," says report, *Recent Developments in Shareholder Litigation Involving Mergers and Acquisitions—March 2012 Update.* "Only a small fraction of these lawsuits, however, resulted in payments to shareholders," adds the report summary; "the majority settled for additional disclosures or, less frequently, changes in merger terms, such as deal protection provisions." Highlights of the 2012 M&A litigation update:

- In 2007, just about half (53 percent) of the deals valued at over $500 million attracted litigation; by 2011, almost all deals of that size (96 percent) spun off shareholder lawsuits.
- During that same time, the absolute count of lawsuits involving deals of less than $500 million also nearly doubled, with 289 cases filed in 2007 and 502 filed in 2011. The number of cases more than doubled, from 2.8 suits per deal in 2007 to 6.8 in 2011.
- Smaller deals were not immune; from 2007 to 2011, 15 deals worth more than $100 million drew 15 shareholder filings or more. Notably, 12 of these deals were announced in 2010-2011.
- Certain industries seem to attract more lawsuits—in particular energy (8.6 per deal) and consumer goods (6.0 per deal).

A flight from Delaware? Delaware courts continue to claim a greater share of the litigation, with case filings climbing from 34 percent of all shareholder suits in 2007 to 45 percent in 2011. At the same time, "the most striking trend in venue choice," the study says, is that while shareholders are challenging the same deal in Delaware, they are increasingly likely to file a suit based on the same facts and claims in California, New York, and Texas, "likely reflecting where many deal targets are headquartered."

Are We Still Confused About Goodwill?

Courts across the U.S. still struggle to determine and divide goodwill in divorce cases—particularly in those jurisdictions that follow the majority rule and require making a distinction between personal goodwill (nondivisible) and enterprise goodwill (divisible). "Or is it the valuator who is confused?" asked presenters Sharyn Maggio (Maggio & Co.) and Miriam Mason (Mason Black & Caballero) at the recent AICPA/AAML National Conference on Divorce in Las Vegas.

Some appraisers might consider Maggio lucky; she practices in New Jersey, which does not recognize the distinction. "It's all divisible," Maggio said, "but

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I work with one practitioner who insists that with respect to a highly skilled professional, there is no goodwill: It's all personal." Other states' courts have agreed, relying on an inverse argument. For example, in a Missouri decision, the husband claimed he was a key employee in his seven-man roofing business, but the court declined to reduce its value by any personal goodwill, finding the husband did not provide the highly skilled professional services that would qualify.

Some courts have determined that all professional goodwill must be salable to be divisible, as evidenced by a noncompete; still others preclude the appraiser from assuming the presence of a noncompete. Notably, in Gaskill v. Robbins (2009), the Kentucky Supreme Court held:

> *While fair market value of [the wife's practice] anticipates what a willing buyer would give a willing seller, the fictional sale must be viewed as a "fire sale," meaning that it must be valued in its existing state. This precludes factoring in a nonexistent non-compete clause, as there is no requirement that [the wife] enter into one other than as a possible negotiated term of a real sale.*

The Gaskill court also required that any goodwill value "must" have a rational basis in accounting principles and "should avoid speculation and assumptions as much as possible." This language is a "little disconcerting," Maggio said. BV appraisers have to make assumptions, particularly regarding goodwill. "But courts don't like it," she added, noting that Gaskill is a "must read" case, no matter where you practice. In fact, this year the case came up again after another trip through the courts, and the appeals court affirmed the previous decisions.

Well-Planned FLP Survives IRS Challenge

***Estate of Kelly v. Commissioner*, T.C. Memo 2012-73 (March 19, 2012)**

It is hard to imagine a better set of facts supporting the formation, funding, and operation of a family limited partnership (FLP), yet still the Internal Revenue Service (IRS) took issue. In 1990, a widow inherited her husband's quarry business plus additional real property and stock. Shortly thereafter, she executed a will leaving many of the specific assets to her three grown children, dividing the residual equally among them.

Some years later, when their mother was suffering from Alzheimer's, the three children (who all managed the family businesses in various capacities) agreed to divide their mother's estate equally and petitioned the probate court to become her co-guardians.

Three FLPs plus a corporate general partner. An estate attorney advised the creation of three FLPs, one for the benefit of each grown child, plus a corporation to serve as general partner (GP) for all three. Each FLP would receive equal assets, while the mother would retain more than $1.1 million in a separate guardianship account for her living expenses.

The corporate GP would also receive a "reasonable management" fee for its services, thus ensuring that the mother (who would own all the stock in the corporation) would receive "adequate income to cover [her] probable expenses for support, care, and maintenance for the remainder of [her] lifetime." Finally, they noted the plan should reduce estate taxes by nearly $3 million.

The probate court approved the plan in June 2003. In December 2003, the mother transferred equal values of stock and other property to the FLPs. Over the next three years, she gave partnership interests to the three children, with appropriate entries to her capital accounts. During the same time, the children maintained the properties and the accounts. They also met regularly as officers and directors of the corporate GP.

In 2005, the mother died. Her federal estate tax return reported her remaining ownership interests in the FLPs as well as her full (100 percent) ownership of the corporate GP. Three years later, the IRS assessed a deficiency of more than $2.2 million based on its determination that the full fair market value of the FLP assets should be included in the decedent's estate pursuant to IRC Sec. 2036(a). In response, her estate argued that the decedent's transfer of assets met the "bona fide sale" exception to Sec. 2036(a) because she had "legitimate and significant nontax reasons" for creating the FLPs and because she received partnership interests proportionate to the value of the transferred property.

Estate (but not tax) planning is paramount. The facts substantially supported the mother's position:

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including the mother's clear and primary concern to distribute her estate equally among her children; her legitimate concern about the management of the assets, which was undertaken by her children; and that she received appropriate partnership interests in the FLPs. Although the probate court petition mentions estate tax planning, the court held that "there is no evidence that tax savings motivated the defendant." Thus the value of the FLP transfers fell within the bona fide sale exception to Sec. 2036(a).

As a second argument, the IRS claimed the parties had an implied agreement that the decedent would continue to enjoy the income from the FLPs during her lifetime. The court rejected this argument too.

The decedent had a bona fide purpose for creating the FLPs, and she had a bona fide purpose for creating the corporation to manage them. She also appropriately reported the full value of the corporation on her estate tax return. Based on all these facts, the court excluded the value of the FLPs from the decedent's gross estate.

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