SEPTEMBER / OCTOBER 2017

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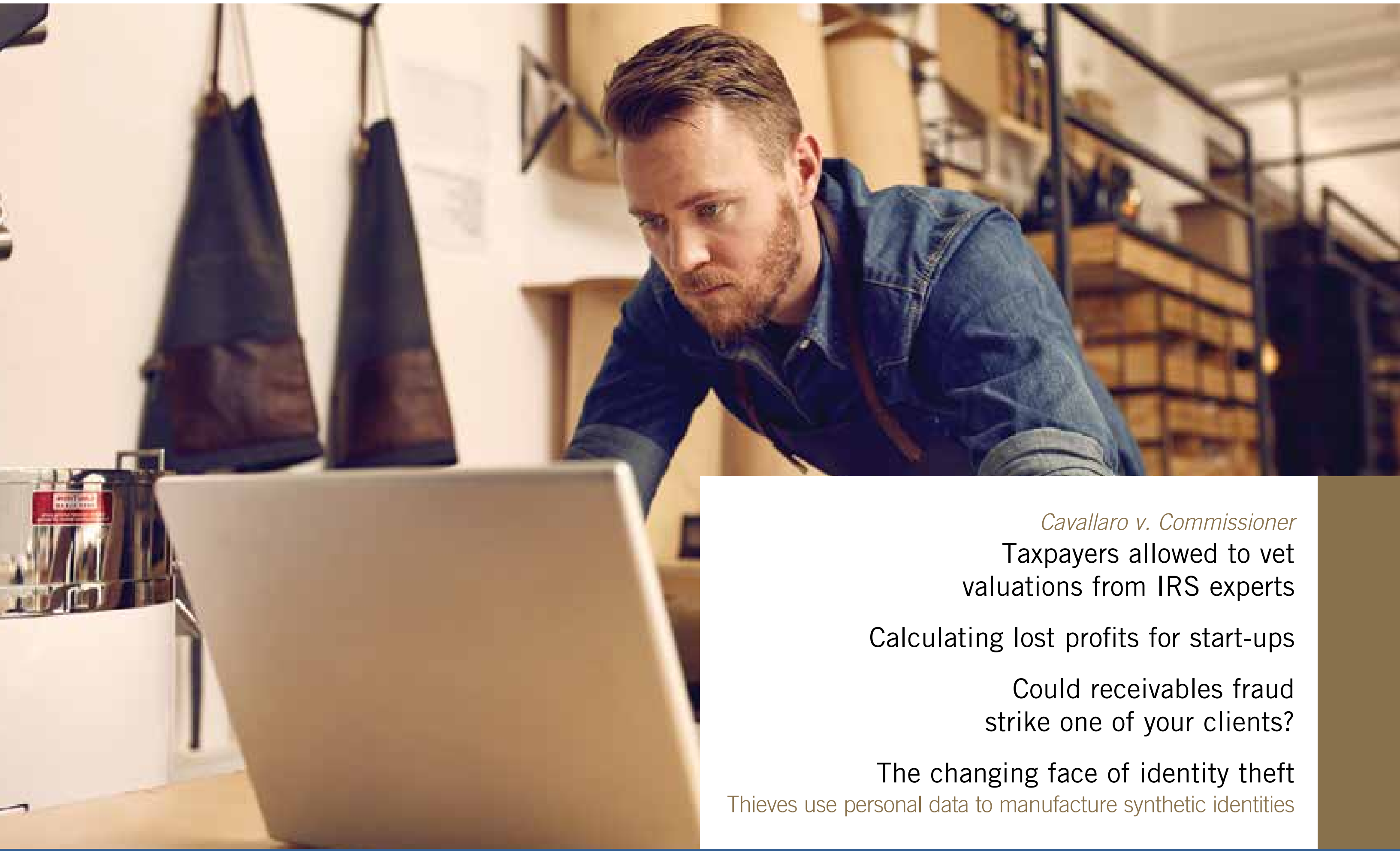

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Cavallaro v. Commissioner

Taxpayers allowed to vet valuations from IRS experts

Is an IRS assessment based on business valuation evidence provided by its expert "arbitrary and excessive"? If a taxpayer raises that issue, the Tax Court should settle it before deciding on the correct tax liability, according to the recent opinion published by the First Circuit Court of Appeals in *Cavallaro*.

Tax scenario under examination

In 1979, a married couple started a contract manufacturing company that made custom tools and machine parts. Their three sons eventually joined the family business.

The company developed a liquid-dispensing system for adhesives in 1982. When the couple decided to refocus on the core business, their sons formed a new company to further develop the liquid-dispensing system. The original company manufactured the redesigned system, and the sons' company sold and distributed it. The two companies' financial affairs overlapped significantly.

In 1995, the companies engaged in a tax-free merger that left the sons' business as the surviving corporation. Before the merger, the taxpayers' accountant estimated that the combined entity would be worth between $70 million and $75 million, allocating only $13 million to $15 million to the parents' original business. The accountant assumed the sons' company already owned the technology for the liquid-dispensing system and that the original company was merely a contractor.

Tax deficiencies

The IRS issued deficiency notices to the parents, finding that the sons' company had no premerger value. As a result, when the companies merged, the taxpayers each made a taxable gift of about $23 million to their sons.

The taxpayers appealed to the Tax Court. Before trial, the IRS obtained a valuation of the two companies on the merger date. The expert assumed the original company owned the technology. He valued the

Burden of proof arguments fail

The taxpayers in *Cavallaro* unsuccessfully argued that the Tax Court should have shifted the burden of proof to the IRS. The appellate court noted that IRS notices of deficiency come with a rebuttable presumption of correctness. The taxpayer bears the burden of proving the tax assessment wrong, except in limited circumstances.

Under the excessive-and-arbitrary exception, the presumption of correctness is overcome when the assessment is shown to be utterly without foundation. The First Circuit found that the taxpayers didn't show that the IRS assessments utterly lacked rational foundation. The fact that the IRS subsequently reduced its original deficiency didn't mean the initial assessment lacked such a foundation.

The presumption also fails if the IRS seeks to establish a deficiency on a theory not included in the original notice. However, the court in *Cavallaro* found that the IRS's theory at trial was simply a refinement of its theory in the initial assessment.

combined entity at $64.5 million, allocating $22.6 million to the sons' business. Based on that valuation evidence, the IRS reduced its initial deficiencies.

At trial, the taxpayers introduced their premerger valuation and another consistent valuation. Both of these valuation experts assumed the sons' company owned the technology. The Tax Court, however, concluded that the original company owned the technology. Based solely on the valuation opinion provided by the IRS expert, the court found gift tax deficiencies in the amount of $7.6 million for the husband (who owned 49% of the original company) and $8 million for the wife (who owned 51%).

First Circuit ruling

On appeal, the taxpayers argued that their burden was to establish that the alleged deficiencies were erroneous — not, as the Tax Court said, to show the proper amount of their tax liability. They claimed that this "legal error" led to another — that is, the court's refusal to consider their evidence that the IRS valuation was fatally flawed.

The First Circuit agreed that the Tax Court had misstated the burden of proof. The appellate court found that the taxpayers merely had to show that the IRS determination was arbitrary and excessive — once a taxpayer does so, it can't be forced to pay the amount assessed, even if it doesn't prove the correct amount owed.

The taxpayers tried to show the IRS's assessment was arbitrary and excessive by challenging its expert's valuation methodology. However, the Tax Court wouldn't hear those arguments. Why? The court reasoned that, even if the taxpayers were correct in their characterization of the assessment, their valuation experts had incorrectly assumed the sons' company owned the technology, so they would be unable to show the proper amount of their tax liability. In the Tax Court's view, this made it pointless to consider the arguments.

The First Circuit, however, ruled that the taxpayers should have been given the opportunity to rebut the valuation and show that the assessment was arbitrary and excessive. If the taxpayers succeeded, the Tax Court should have quantified the tax liability itself.

Next steps

The First Circuit remanded the case for evaluation of the taxpayers' challenges to the IRS valuation. If the Tax Court determines the assessment was arbitrary and excessive, it then must determine the proper tax liability. In doing so, the appellate court said that the Tax Court may consider additional evidence, including a new valuation. So, the taxpayers may, at the Tax Court's discretion, be given a second shot at offering an expert opinion — one not based on a faulty assumption. ■

Calculating lost profits for start-ups

Lost profits estimates are customarily based off of a company's historical performance. But what happens when the victim of a dispute, breach or another tortious interference is a start-up without a track record of profits? The nature of start-ups causes projections of future revenues and profits to be subject to much greater uncertainty. These situations typically call for alternative methods to arrive at a reliable lost profits calculation.

Traditional approach: Look to the past

To calculate lost profits, the expert determines the business's lost revenue using a variety of techniques, such as the yardstick and before-and-after methods. Projected lost revenue is based on certain assumptions and adjusted by appropriate profit margins to reach lost profits.

Regardless of the method applied, the expert needs projected *future* revenue and profit margin numbers. But this can prove difficult with new businesses, because they lack financial histories and, in some cases, comparable industry data.

To project future revenue, experts typically use data from historical company performance, industry, and general economic trends and forecasts. With a new business, however, an expert may find insufficient performance data, insufficient firm data to correlate with industry trend data or a product so new that no projections have yet been made.

Similar problems complicate the process of determining profit margins, which requires analysis of a company's fixed and variable costs. An expert will usually use historical company performance, industry profit margins, and internal forecasts based on projected revenue and cost structures. But a new business may offer insufficient data for analysis, and, if it markets a new product or service, comparable businesses might not exist.

Find unconventional solutions

Determining accurate lost profits damages for new businesses isn't hopeless, though. Experts have alternative forecasting methods that can lead to supportable lost profits claims.

For instance, they can use company projections for future revenue if the available data allows calculation of lost profits with "reasonable certainty" — in other words, the damages aren't merely speculative. The expert also may apply industry growth rate projections to existing company data and develop multiple sales projections using varied combinations of actual and projected data.

If the multiple projections arrive at similar conclusions, the expert can offer those findings as evidence of lost revenue. After lost revenue is calculated, the expert might use firm-specific data to model the cost structure by determining fixed and variable costs and the cost of goods sold.

Even when no useful firm-specific data can be identified, experts can cull useful information from outside sources. For example, they might look at models and studies of new-product life cycles to obtain market share and penetration estimates useful in projecting revenue.

Internal data and reports, industry forecasts and other sources can then assist in formulating profit margins. And many governmental agencies, trade associations and research organizations issue regular reports that provide data — including expected demand, price and cost structures — that can be wielded to validate lost profits projections.

Experts also use discount rates. The discount rate applied to lost profits must reflect the riskiness and probability that the business would have realized the projected lost profits. It may be necessary to add a premium to the discount rate to account for overly optimistic internal forecasts. Or, when a business is in an early stage, experts may add an additional premium to the discount rate because lost profits aren't as easily projected as they are for an established business.

Put an expert on your team

Claims for lost profits damages arise in many types of litigation, including shareholder disputes, insurance litigation, breach of contract and intellectual property actions. Unfortunately, many of the plaintiffs in these cases are start-ups that lack the financial resources to prevent litigation and defend against wrongdoing. The good news is that entrepreneurs can estimate lost profits with confidence by hiring valuation specialists who are trained in such out-of-the-box thinking and creative — but defensible — solutions. ■

Could receivables fraud strike one of your clients?

From invoices and payments to discounts and write-offs, many transactions are recorded to accounts receivable. This makes receivables a popular fraud target. Moreover, receivables schemes tend to be hard to detect, allowing them to run for long periods and cause significant losses.

Common schemes

Put simply, receivables fraud happens when dishonest employees divert customer payments for their personal use. They can accomplish this in various ways, including:

Lapping. This is the most common type of receivables fraud. It involves the application of receipts from one account to cover misappropriations from another. For example, rather than credit Customer A's account for its payment, a dishonest employee pockets the funds and later posts a payment from Customer B to A's account, Customer C's payment to B's account and so on.

Write-offs and discounts. Instead of crediting a payment to the customer's account, fraudsters might pocket the funds and then record a bad debt write-off or discount to reduce the customer's account. This allows the customer's account to reflect the expected current balance despite the diversion of incoming payments.

Additionally, employees may report sales to phony accounts to artificially inflate the company's financial results — or when their compensation is based on sales (rather than collections). Sales to phony customers generate bogus receivables that will never be collected.

Prevention tips

Clients can implement numerous preventive measures to head off receivables fraud. For example, segregation of duties can eliminate the opportunity for employees to steal. In terms of preventing receivables fraud, the employee who handles incoming payments from customers should be separate from the person who handles invoicing. Large companies may even task a different employee with managing customer complaints. Why? Customer complaints can provide a red flag that receivables fraud has occurred — and fraudsters who receive complaints are likely to stifle them.

In addition, businesses should require mandatory vacation time for all employees. Receivables schemes typically require their perpetrators to remain ever vigilant to avoid detection. For this reason, it's also advisable to rotate job duties among employees.

Methods of detection

Receivables fraud schemes are difficult — but not impossible — to detect. And the transparent use of the detection tools can also deter those contemplating fraud.

If a client discovers anomalies in the receivables ledger or notices a receivables clerk is acting suspiciously, it may be time to call in a forensic accounting expert. He or she may start by tracing a sample of cash receipts to the sales ledger and deposit slips. The purpose of this exercise is to find discrepancies in dates, payee names and amounts. The expert also may compare deposit slips against the books and send requests for confirmations to a sample of customers to verify current balances and payment histories.

Another hot spot is bad debt write-offs. A forensic accountant is likely to review this account, including the reasons provided for specific write-offs. He or she also will be on the lookout for accounts with unexplained credits, increased customer credit limits and random adjustments to the accounts receivable ledger.

Most important, the expert will interview company personnel in a confidential manner, searching for potential weaknesses in the company's internal controls, signs of collusion and other information. After all, tips are the most common method of detection for any type of fraud.

Best defense is a strong offense

Despite their best fraud prevention efforts, employers may still fall victim to receivables fraud and other scams. If one of your clients suspects foul play, a forensic accountant can help uncover the requisite proof. ■

The changing face of identity theft

Thieves use personal data to manufacture synthetic identities

People have been worried by the prospect of identity theft for decades. But many clients are unaware of another type of identity fraud that's potentially riskier: synthetic identity fraud. Forensic experts estimate that this type of scheme is more prevalent than so-called "true-name" fraud.

How it works

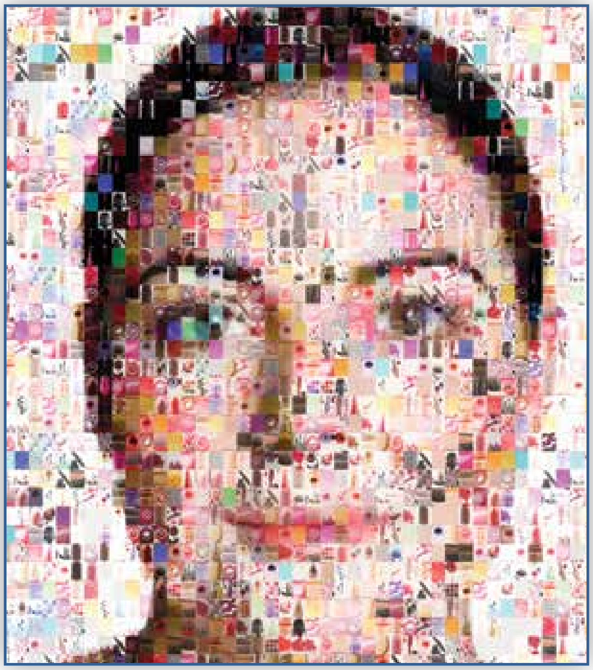
Traditionally, identity theft occurs when a thief assumes a person's identity and personal information. In other words, the thief pretends to be the victim. Synthetic fraud works differently.

Here, the perpetrator typically combines real and fabricated information to produce a fictitious identity and then uses it to apply for credit. Alternatively, a perpetrator could combine the actual information of multiple identities. For example, someone could use your client's Social Security number (SSN) with another individual's name and a third person's address.

A fraudster's initial credit application using the synthetic identity will likely be rejected. But credit reporting agencies will open a new credit file for the identity. The fraudster can then try again — and stands a good chance of approval. Some card issuers offer small credit lines to applicants with little or no credit history. These "starter" cards can be used to establish a credit history, paving the way to more lucrative opportunities for fraud in the future.

Why it's so costly

What's at risk if your client's SSN is involved in one of these scams? Fragmented (or sub) files could be associated with their SSN at credit reporting agencies. Because many agencies don't bother cross-referencing SSNs with other identifiers (such as names or addresses), victims may have fragmented files for entirely different identities linked to their main credit files.



Credit agencies can take months or even years to clean up negative data from fragmented files. In the meantime, creditors are relying on false information in your client's credit reports.

Experienced perpetrators often seek out SSNs that aren't actively used. For example, a thief who incorporates a child's SSN might not be discovered until the victim tries to apply for student loans or jobs with employers that check credit histories.

How to help

Take the time to educate your clients about synthetic identity fraud. Explain how these scams work and what's at risk. Also suggest preventive measures, including obtaining free credit checks annually and subscribing to identity theft protection services that provide real-time monitoring. Forensic accounting experts can help review clients' credit reports for signs of synthetic fraud and help them work with credit agencies to correct errors in an expedient manner. ■

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