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ADVOCATE'S EDGE

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Limited partner or assignee interest: Tax Court sides with IRS

Wealthy taxpayers sometimes incorporate family limited partnerships (FLPs) in their estate plans to help minimize federal estate and gift taxes. Historically, the IRS has been aggressive in challenging such arrangements. In *Estate of Streightoff*, the U.S. Tax Court sided with the IRS, offering a valuable reminder that, when it comes to the federal tax effect of intrafamily transfers of interests, labels aren't determinative. Rather, the court will consider the *substance* of the transaction.

Lure of FLPs

The value of limited partner interests in an FLP generally is discounted from the value of the partnership's underlying assets to account for the lack of marketability and lack of control associated with limited partner interests. This can mean lower gift taxes for family members.

FLPs also can reduce estate taxes. When the taxpayer who establishes an FLP passes away, his or her taxable estate usually will be reduced. This is because it includes only the value of any retained partnership interests, not the value of the FLP's underlying assets.

The IRS sometimes asserts that the undiscounted value of an FLP's assets is includable in the decedent general partner's taxable estate. In the recent case, however, it was a transfer of an FLP interest to a revocable trust under scrutiny.

Transfer in question

In October 2008, a taxpayer, now deceased, formed an FLP under Texas law. The partnership was essentially an asset holding company that managed a portfolio of cash and investments. The general partner in the FLP was a limited liability company (LLC) managed by the decedent's daughter. The decedent, his children and a former daughter-in-law were the original limited partners.

On the day the partnership was created, the decedent formed a revocable trust for himself, with the daughter as the sole trustee. She executed an agreement titled "Assignment of Interest" that transferred her father's 89% interest in the partnership to the trust.

After the decedent's death in May 2011, his estate valued the transferred interest at about $4.6 million. The IRS subsequently sent a notice of deficiency for nearly $500,000, arguing that the value of the interest was about $6 million.

The estate turned to the Tax Court for relief. It argued that the transfer agreement created an *assignee* interest in the decedent's limited partnership interest under Texas state law and, therefore, was properly valued. The IRS countered that the agreement didn't create an assignee interest. Instead it transferred to the trust a *partnership* interest and, with it, all the rights of being a limited partner.

Split verdict on the valuation discounts

In *Estate of Streightoff*, the U.S. Tax Court considered whether a discount for lack of control (DLOC) and a discount for lack of marketability (DLOM) apply when valuing the 89% limited partner interest that was transferred to the trust. The estate's expert valued the interest as an assignee interest and applied a 13.4% DLOC and a 27.5% DLOM. The IRS's expert valued it as a partnership interest, with only an 18% DLOM.

Because the court held that a partnership interest had been transferred, it disallowed the estate's 13.4% DLOC. The court noted that, under the partnership agreement, limited partners with a 75% interest had the power to remove general partners, which would terminate the partnership. Prospective purchasers of the interest would pay more, not less, for that degree of control.

The court ruled a DLOM was appropriate, however. Because the estate's expert had incorrectly valued an assignee interest, its discount was too high. So, instead, the court accepted the IRS expert's 18% DLOM.

Tax Court decision

The Tax Court began its analysis by recognizing that state law generally determines the type of property interest transferred for federal estate tax purposes. However, the federal tax effect of a particular transaction is governed by its *substance*, rather than its form. The court emphasized that it looks beyond formalities when evaluating intrafamily partnership transfers. In this case, it concluded that both the form and the substance (or "economic realities") established that the decedent had transferred a limited partnership interest to the trust.

In regard to form, the court looked at the transfer agreement and provisions in the partnership agreement that allowed transfers of limited partnership interests and the admission of substituted limited partners. It found that the transfer satisfied all the partnership agreement's conditions for a transferee to be admitted as a substituted limited partner.

As for substance, regardless of whether an assignee or a limited partnership interest had been transferred, no substantial difference existed before and after the transfer. For example, the partnership agreement provided that only the general partner had the right to direct the business. Neither limited partners nor assignees had managerial rights.

The court conceded that, under the agreement, assignees also had no rights to any information on the partnership's business or to inspect books or records. It pointed out, though, that this distinction was ultimately irrelevant because the daughter was both a partner entitled to that information and the sole trustee.

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The court similarly dismissed assignees' lack of voting rights. It found the restriction had no practical significance here, because the limited partners had never before held a vote.

Critical consideration

FLPs remain a viable estate planning tool. Your clients need to understand, though, that the proper tax treatment will depend on both the form and the economic realities of the property transfers. ■

How journal entries may signal fraud

With a median loss of $800,000, financial statement frauds are the costliest type of white collar crime, according to the *2018 Report to the Nations* by the Association of Certified Fraud Examiners (ACFE). Fortunately, auditors and forensic accountants may be able to detect financial misstatement by testing journal entries for errors and irregularities. Here's what they look for and how these tests work.

Unearthing suspicious entries

Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit*, provides valuable audit guidance that can be applied when investigating fraudulent financial statements. It notes that "material misstatements of financial statements due to fraud often involve the manipulation of the financial reporting by … recording inappropriate or unauthorized journal entries throughout the year or at period end."

Financial statement frauds come in many forms. For example, out-of-period revenue can be recorded to inflate revenue. Repair costs can be improperly capitalized as fixed assets to boost earnings. Accounts payable can be understated by recording postclosing journal entries to income. Or expenses can be reclassified to reserves and intercompany accounts, thereby increasing earnings.

To detect these types of scams, SAS 99 requires financial statement auditors to:

- Learn about the entity's financial reporting process and controls over journal entries and other entries,
- Identify and select journal entries and other adjustments for testing,
- Determine the timing of the testing, and
- Interview individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries or other adjustments.

Forensic accounting experts also follow audit guidelines when investigating allegations of financial misstatement. And financial statement auditors may call on these experts when they notice significant irregularities in a company's financial records.

Testing journal entries

AICPA Practice Alert 2003-02, *Journal Entries and Other Adjustments*, identifies several common denominators among fraudulent journal entries. Auditors will ask for access to the company's accounting system to test all of the journal entries made during the period for signs of fraud.

Specifically, they tend to scrutinize entries made 1) to unrelated, unusual or seldom-used accounts, 2) by individuals who typically don't normally make journal entries, 3) at the end of the period or as postclosing entries that have little or no explanation or description, 4) before or during the preparation of the financial statements without account numbers, and 5) to accounts that contain transactions that are complex or unusual in nature and that have significant estimates and period-end adjustments.

> Computerized testing evaluates the entire dataset, reducing the risk of overlooking critical evidence.

Other red flags include adjustments for intercompany transfers and entries for amounts made just below the individual's approval threshold or containing large, round-dollar amounts.

Auditing with computers

SAS 99 specifically recommends "computer-assisted audit techniques," which typically offer a more effective and efficient method of searching for unusual entries than manual testing. Computerized testing evaluates the entire dataset, reducing the risk of overlooking critical evidence. Such testing also allows fraud experts to devote more time to other aspects of the investigation, such as gathering information about the business and interviewing employees.

Computerized testing can prove particularly helpful in situations where manual testing is largely ineffective — for example, when entries exist only in an electronic format and the desired data must be extracted. In such situations, a forensic expert may use data extraction tools and other systems-based techniques to identify appropriate entries for further investigation.

One technique simulates different types of accounting transactions. The test follows the flow of transactions as they work their way through the system, uncovering any internal control weaknesses or programming that the fraud perpetrator might have embedded.

Combining technology with expertise

Computer-assisted journal entry testing doesn't replace a skilled auditor or fraud examiner. Instead, these tools free up the expert's time, allowing him or her to focus on high-risk journal entries and anomalies. ■

Applying the *Daubert* standard in federal cases

Under Rule 702 of the Federal Rules of Evidence, an expert witness may testify if scientific, technical or other specialized knowledge will help a judge or jury make sense of evidence or understand facts. A 1993 U.S. Supreme Court case — *Daubert v. Merrell Dow Pharmaceuticals Inc.* — put this rule to the test, affirming judges' roles to act as gatekeepers against "junk science."

More than 25 years later, hundreds of experts are still being challenged under *Daubert* each year. How can you help ensure that your expert's opinion will be admitted into evidence?

Focus on reliability and relevance

Rather than addressing the accuracy of an expert's opinion, the *Daubert* test focuses on the reliability and relevance of an expert's analyses. It asks the following questions:

- Has the opinion been tested?
- Has it been peer reviewed by other practitioners?

- Has the methodology been published in professional journals?
- What's its known error rate?
- Has the expert's profession established standards to control its use? And, if so, has the expert complied with these standards?
- Is it generally accepted among members of the scientific community?

The Supreme Court intended courts to consider these questions with flexibility and consider the method's replicability. For instance, a new method might pass muster if another expert can replicate the expert's analyses — and if the expert can persuade the court that the method is appropriate for the case.

Daubert dealt specifically with medical testimony. So, the legal community initially questioned whether it applied to technical or specialized expert testimony. But in 1999, *Kumho Tire Company v. Carmichael* ended this debate, extending the scope of *Daubert* beyond scientific testimony to other academic disciplines, including accounting and finance.

Do your homework

When assessing an expert's chances of withstanding a *Daubert* challenge, it's important to look beyond education, professional designations, industry experience and reputation for qualities that could lead to exclusion during such a challenge. Make sure to review relevant *Daubert* case law when challenging opposing experts or defending your expert.

Think beyond mathematical errors and speculative analyses. In some cases, courts may disqualify financial experts for cherry-picking documents and data sets that support their side's financial interests. For example, in the 2018 U.S. District Court case *Rover Pipeline LLC v. 10.55 Acres of Land*, a business valuation expert was harshly criticized, because, when building up the cost of equity, she "used the 'generally accepted' Duff & Phelps numbers when they raised her valuation but ignored the guide's suggested number when it lowered her valuation."

Further, courts expect a high level of due diligence concerning the company's operating history and its financial projections. For instance, a disclaimer that the valuation expert accepted a company's projections at face value (without assessing reasonableness) might raise a red flag during a *Daubert* hearing.

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Other potential pitfalls to avoid include ongoing professional relationships and contingent fees that may impair a financial expert's perceived objectivity. Reliable experts maintain independence and avoid acting as advocates for their clients. Additionally, an expert's testimony shouldn't extend beyond his or her area of expertise.

Assess the situation

An objective review by a third expert can help reveal both experts' mistakes and weaknesses. Such a review could be helpful in the face of a *Daubert* challenge — or if you're considering challenging the expert hired by the opposition. Be aware, however, that *Daubert* applies in federal cases. Some state and local jurisdictions may hold expert witnesses to different standards of admissibility. ■

R. Kashmiry & Assocs., Inc. v. Ellis

Valuations can preempt shareholder agreement litigation

When entrepreneurs team up to form a new (or combined) business, they often have the forethought to include business valuation provisions in their partnership or shareholder agreements. These provisions help facilitate clear and easy resolution in case an owner leaves the business. However, a recent case demonstrates that simply drafting a business valuation provision may not suffice. Hiring an outside expert to value the business on a routine basis can provide an added level of protection against protracted litigation.

The owners of a merged insurance agency learned this lesson the hard way when the minority shareholder left the business. At least three rounds of litigation have ensued, largely due to the fact that the owners never had the company valued after the merger.

Valuation provision

In *Kashmiry v. Ellis*, the shareholders' agreement provided that, if a triggering event occurred, the majority shareholder had the option to buy the minority shareholder's stock. If he didn't, the company would have to buy the stock based on an "agreement price" that could be calculated in one of two ways.

1. Annual consensus. The shareholders could annually agree on the fair market value of the stock and issue a certificate of valuation that would be valid for a year.

2. Outside appraisal. The shareholders could appoint a qualified appraiser when a triggering event occurred.

The shareholders' agreement specified the factors a business valuation expert should use to determine price, giving "great weight to any prior valuations."

When the minority shareholder was terminated in 2014, the majority shareholder chose not to purchase his shares. Unfortunately, no valid certification of valuation existed at the time of this triggering event. So the company hired a valuation expert who valued the shares at about $2,000 each.

Court positions

The trial court valued the minority shareholder's interest at $7,500 per share, which was the price the minority shareholder had paid five years earlier. The court considered this purchase price a "prior valuation." The majority shareholder appealed.

The Ohio Court of Appeals faulted the trial court for relying on the $7,500 purchase price as the sole indication of value. While the original price may be deemed a valuation, it was only one valuation, "and five years old at that." Giving such a valuation sole weight was erroneous and contrary to the terms of the shareholders' agreement.

To be continued

The appellate court remanded the case for another valuation of the stock, more than four years after the triggering event occurred. If the parties had obtained annual valuations, they might well have saved much time, money and aggravation. ■

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