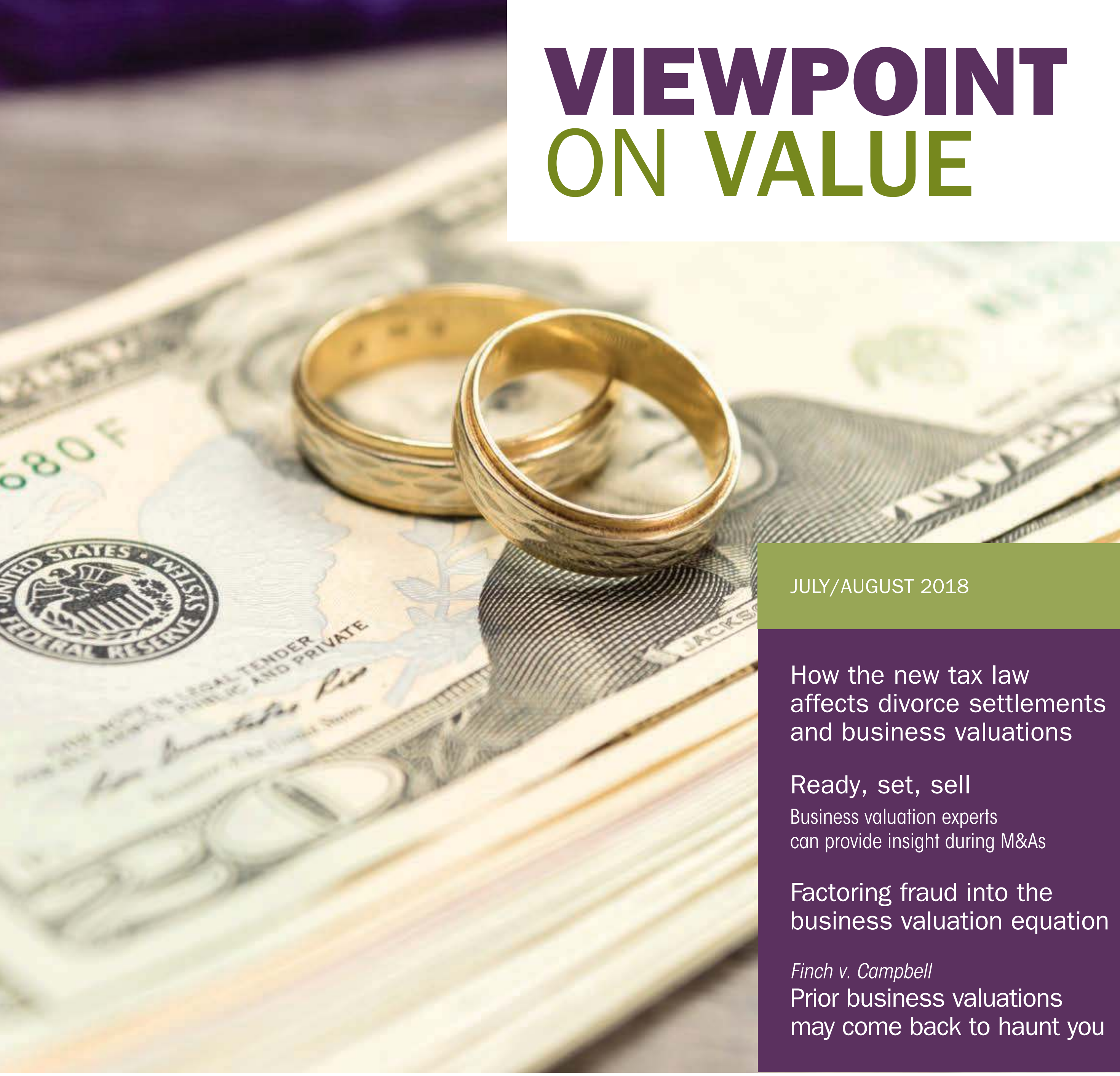
VIEWPOINT ON VALUE



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Business valuation experts can provide insight during M&As

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Do you have a **Question?** or want to speak to
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How the new tax law affects divorce settlements and business valuations

Business valuation experts often help formulate settlement offers in divorce cases. In addition to valuing business interests held by a marital estate, these experts can suggest equitable asset allocations and determine reasonable alimony and child support amounts. Now there's a new twist to consider: the Tax Cuts and Jobs Act (TCJA).

How does the new law affect alimony?

Before the TCJA was enacted, maintenance payments that met the tax-law definition of alimony could be deducted by the payer for federal income tax purposes. The recipient had to report the money as taxable income. (See "Defining alimony for pre-2019 settlements" on page 3.)

The tax deduction for alimony payments is eliminated for divorce agreements reached after 2018. For monied spouses, this change could be expensive, because the tax savings from deducting alimony payments can be significant. Most states have statutory guidelines for structuring alimony awards, which could become burdensome under the TCJA unless states revise their guidelines.

This new treatment of alimony will apply to payments under divorce or separation instruments that are modified after December 31, 2018. But the modification must specifically state that the new TCJA treatment applies.

Treating alimony as deductible support generally leaves more money in the marital estate — and less in the hands of the IRS. So, most alimony payers and recipients would prefer to finalize their divorces in 2018.

What other TCJA provisions might affect divorce settlements?

The TCJA contains several changes that will affect individual and business taxpayers. Those that may affect divorce settlements include:

Reduction of state and local tax (SALT) deductions. For 2018 through 2025, itemized deductions for personal SALT amounts are limited to a combined total of only $10,000 ($5,000 if you use married filing separately status). The limitation applies to state and local 1) income (or sales) taxes, and 2) property taxes. The change could upset the fairness of a negotiated settlement for the spouse who received the primary residence and/or a vacation home. (Individuals can still deduct all property taxes on *rental* properties under the new law, however.)

Expanded use of Section 529 savings. Contributions to Sec. 529 plans aren't tax deductible, but distributions from 529 plans aren't subject to federal tax, if they're used to pay for qualifying higher education costs at an eligible institution. Under the new tax law, individuals can take tax-free distributions of up to

$10,000 per year from a 529 plan to cover tuition at a public, private, or religious elementary or secondary school, starting in 2018. This change could create a financial hardship if a noncustodial parent had planned to use the Sec. 529 plan to pay for college expenses.

Reduction in business tax rates. Starting in 2018, a flat 21% federal income tax rate applies to C corporations. In addition, the new law eliminates the alternative minimum tax (AMT) for C corporations.

Tax rates were also effectively reduced for sole proprietorships and so-called "pass-through" entities (including partnerships, limited liability companies and S corporations). The reduction will be achieved from a new 20% qualified business income (QBI) deduction, which is available for 2018 through 2025. Numerous rules and restrictions apply to the QBI deduction.

These changes could increase the value of some businesses and provide an unintended boon for a spouse who was awarded a private business interest in a divorce settlement. But it may be difficult to understand the full effects of the TCJA on a business, thereby complicating settlements involving private business interests.

Your expert understands the new tax law

Experts who combine business valuation skills with an understanding of the new tax law can be a valuable resource when drafting or revising divorce agreements. There may be situations — such as a change in the income levels of the alimony payer or the alimony recipient — where applying these new rules voluntarily could be beneficial for the parties to an existing settlement. ■

Defining alimony for pre-2019 settlements

For pre-2019 alimony payments to be tax deductible, payers must satisfy the following eight requirements:

1. The payment must be made under a written decree of divorce, separate maintenance or separation.

2. The payment must be to, or on behalf of, a spouse or ex-spouse. Payments to third parties, such as attorneys and mortgage lenders, are permitted if made under a divorce or separation agreement or at the written request of the spouse or ex-spouse.

3. The divorce or separation instrument can't state or effectively stipulate that the payment isn't alimony because it isn't deductible by the payer or won't be included in the payee's gross income.

4. After the divorce or legal separation, the ex-spouses can't live in the same household or file a joint tax return.

5. Payments must be made in cash or a cash equivalent.

6. Payments can't be classified as fixed or deemed child support. (The rules regarding what constitutes child support are complicated.)

7. The payer's tax return must include the payee's Social Security number.

8. The obligation to make payments (other than payment of delinquent amounts) must cease if the recipient dies. State law controls if the divorce papers are unclear about whether payments must continue (to the estate and eventually to beneficiaries of the estate). If, under state law, the payer must continue to make payments after the recipient's death, the payments can't be alimony.

Payments that fail to meet the tax-law definition of alimony are generally treated as child support payments or payments to divide the marital property. Such payments represent nondeductible personal expenses for the payer and tax-free income for the recipient.

Ready, set, sell

Business valuation experts can provide insight during M&As

A recent survey reported an active merger and acquisition (M&A) market for small businesses in 2017 — and that momentum has continued in 2018. Here's how business valuation professionals can help owners prepare for sale and increase the chances of receiving a premium selling price.

Survey findings

In 2017, small business transactions set records in terms of deal volume and average pricing multiples, according to the *Market Pulse Report.* This quarterly survey evaluates market conditions for businesses with market values of up to $50 million. It's a joint effort of the International Business Brokers Association (a nonprofit trade association of business brokers), M&A Source (a professional association of middle-market M&A intermediaries) and Pepperdine Graziadio Business School.

On average, sellers realized 99% of the asking price in 2017, compared to a 90% realization rate in 2016. Last year, the hottest sectors were:

- Personal and business services,
- Restaurants,
- Manufacturing, and
- Construction.

Nearly three-quarters of brokers who participated in the survey believe that sales of small businesses will continue to increase in the coming months. Reasons for their optimism include the retiring Baby Boomers, relaxed small business lending requirements, historically low interest rates and increased cash flow from tax cuts.

Prep work

Business owners looking for an exit strategy can take proactive steps to maximize their selling prices. Some small businesses operate in tip-top shape, but most could use some housekeeping to prepare for sale.

For example, it's common for owners nearing retirement or experiencing burnout to scale back their involvement in their business. That can be a huge mistake! Small business buyers typically base their offers on multiples of the one to three years of seller's discretionary earnings (SDE) or earnings before interest, taxes, depreciation and amortization (EBITDA). Owners who step up their involvement in the business prior to selling typically sell at a premium over businesses that simply maintain the status quo.

In addition, businesses with clean financials — meaning fewer nonoperating items on the balance sheet and fewer personal expenses flowing through the income statement — are generally more attractive to potential buyers. For instance, owners should consider selling underperforming business segments and assets that are unrelated to the core business. They also might adjust family member salaries and perks to reflect what a third party would receive for similar services.

Some small businesses operate in tip-top shape, but most could use some housekeeping to prepare for sale.

During due diligence, prospective buyers will assess the condition of the company's assets. So, it's important to keep equipment and facilities well maintained. They'll also evaluate internal controls. Inadequate controls over expensive equipment and intellectual property can impair selling prices, especially in the retail, health care and advanced manufacturing sectors.

Human capital is another critical asset from a buyer's perspective. So, prior to putting the business up for sale, owners should train employee-managers on how to run the show with the owners' help and, if possible, require employees to sign employment and noncompete contracts. These steps help ensure a smooth transition from the seller to the buyer.

Valuable insight

A business valuation professional can provide objective, real-world insight to owners who are contemplating a sale. In addition to helping owners set reasonable asking prices, they can conduct mock due diligence prior to putting the business on the market. This exercise can help the owners identify weaknesses and risks from the perspective of potential buyers. Taking proactive measures to eliminate or minimize these negatives will likely maximize the selling price and minimize the time to close a deal. ■

Factoring fraud into the business valuation equation

Over time, fraud can impair the value of a business. In addition to stealing assets, employee theft may harm a company's reputation and lower employee morale and productivity. A company's owners can also manipulate financial records to artificially inflate (or decrease) the value of the business, depending on which serves their financial interests.

Business valuations typically are *not* designed to unearth dishonest behaviors. However, experts need to be on the lookout for signs of fraud and, when necessary, expand the scope of the engagement to achieve an accurate conclusion.

Fraud risks

Value is a function of risk and return. One critical risk factor experts consider is fraud. Some businesses are more vulnerable to fraud than others.

The fraud risk assessment starts with a company's internal controls. When interviewing management, business valuation experts ask about the company's policies and procedures to protect assets, improve operating efficiency and ensure reliable financial statements. A company's first line of defense against fraud is a strong system of internal controls, which may include:

- Physical and digital controls (for example, locks, passwords, cameras and security systems),
- Fraud training programs,
- Job descriptions that call for segregation of duties and job rotation,
- Mandatory vacation policies,
- Background checks, and
- Whistleblower hotlines.

Internal controls can be intentionally circumvented and thus are less effective if managers override the systems or become lax in supervising subordinates. These loopholes undermine a company's efforts to detect and prevent fraud. The risk of fraud can be reduced if the company's financial statements are audited by an outside accounting firm — or if the company's internal audit department conducts physical inventory counts or surprise audits of certain high-risk accounts during the year.

Certain industries also tend to be more susceptible to fraud than others. High-risk sectors include banking and financial services, government and public administration, and manufacturing, according to the most recent *Report to the Nations on Occupational Fraud and Abuse* issued by the Association of Certified Fraud Examiners (ACFE).

Fraud-risk adjustments

Business valuation experts rely on financial statements to estimate value. To the extent that financial statements contain fraud, an appraisal will be inaccurate, unless properly adjusted.

When a business valuation expert analyzes a company's financial statements, he or she might unearth red flags of fraud. Examples include a disconnect between revenue growth and changes in key assets (such as receivables or inventory) or sudden changes in gross margin [(revenue – cost of sales) ÷ revenue].

So, what happens if the valuation professional suspects fraud, based on preliminary assessments of the company's internal controls, industry and financial statements? Some business valuation professionals are cross-trained in both valuation and forensic accounting. Others work at large firms that provide both types of services. When these experts suspect fraud, they typically ask a client to expand the scope of the engagement to include forensic accounting services. This usually requires a revised engagement letter or an addendum to the existing contract.

Sole practitioners without forensic accounting training will generally refer the client to a separate forensic accounting specialist. This expert can help make the requisite adjustments to accurately value the business — and build a fraud case, if necessary. Together, the valuation expert and the forensic specialist can estimate economic damages resulting from fraudulent activity.

Fraud can be a touchy subject. Unlike traditional CPAs, forensic accountants understand how to gather evidence without violating employee rights or destroying evidence. Their reports are designed to help resolve disputes and support formal fraud allegations.

Special circumstances

Fraud can unexpectedly strike any business, large or small. But certain types of engagements — such as shareholder disputes and divorces — can provide the motive to hide assets and downplay income. Experts are particularly mindful of fraud risks when valuing a business for these purposes. ■

Finch v. Campbell

Prior business valuations may come back to haunt you

In *Finch v. Campbell,* two valuation reports were prepared for a law firm. The conclusions differed significantly. Instead of seeking an explanation for the discrepancy, the court simply rejected the plaintiff's appraisal evidence. An appellate court affirmed the circuit court's "equitable discretion" to exclude the expert's opinion. Here are the details.

Marital dissolution, partnership dissolution

Two attorneys dissolved their law firm, effective August 1, 2012. They didn't have a written partnership agreement but equally shared the partnership's expenses and profits. The partnership operated on a cash basis. Prior to dissolving the partnership, the defendant locked the plaintiff out of the firm's office space, leaving him with only a laptop computer.

The partnership continued to exist after its effective date, as operations wound down, bills were paid, invoices were sent to clients and receivables were collected. After the dissolution, the defendant opened a new law firm.

Both parties filed claims against each other: The plaintiff felt he had been improperly excluded from the law firm and its profits. The defendant counterclaimed that the plaintiff had failed to record or bill time for legal services rendered for several clients to lower his income for his marriage dissolution proceedings. The defendant argued that the plaintiff's underbilling put his personal interests above those of the partnership.

In December 2014, the plaintiff's business valuation expert testified that the partnership's "liquidity value" was approximately $412,000 as of July 2012. However, the same expert, in 2012, had valued the partnership for the plaintiff's marital dissolution case at roughly $1,000 — and the family court accepted that valuation when divvying up his marital estate.

The Circuit Court of Jackson County, Missouri, disregarded the testimony of the plaintiff's valuation expert. Instead, the court relied on a forensic accounting analysis conducted by an unbiased, court-appointed CPA to identify unrecorded receivables and unbilled work-in-progress. Based on that analysis, the court valued the plaintiff's interest in the partnership at approximately $61,000.

Both parties appealed the decision. But the Western District of Missouri Court of Appeals upheld the circuit court's value of the partnership interest, along with its decision to reject the appraisal evidence provided by the plaintiff's expert. The appellate court cited previous Missouri case law, which concluded, "[P]arties are not allowed to take clearly inconsistent positions in differing lawsuits."

Lesson learned

There may be valid reasons for a discrepancy between two opinions. To avoid looking like a "hired gun," an expert's report should identify prior business valuations and explain any differences between the conclusions. Likewise, clients should always disclose all prior valuations to their experts to prevent them from being blindsided in court. ■

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Michael B. Lehner is a Principal in the Bridgewater office of zbt Certified Public Accounting & Consulting, LLC. In his capacity as a recognized expert, Michael has prepared business valuations for various purposes including shareholder disputes, matrimonial proceedings, acquisitions and sales of businesses, gift and estate planning, succession planning, and commercial litigation. He also has extensive experience in complex litigation matters, including determination of damages and lost profits, and fraud and forensic investigations.

Michael has more than 30 years of experience with a focus on valuation, litigation support, and taxation issues. He has additional expertise in auditing, financial statement analysis and consulting. His traditional accounting experience, includes taxation and financial statement reporting for closely held businesses, with a concentration on professional practitioners, real estate developers, construction contractors, retailers, manufacturers, and computer hardware and software providers.

Michael earned his Bachelor of Science Degree from the University of Delaware. He holds accounting certifications in both New Jersey and New York. Michael is a member of the American Institute of Certified Public Accountants (AICPA), a recipient of the AICPA's Accredited in Business Valuation (ABV), and Certified in Financial Forensics (CFF) designations. Michael is a member of the New Jersey Society of Certified Public Accountants (NJSCPA), where he was the Group Leader of the Business Valuation, Forensic & Litigation Services Interest Group, and is currently on the Steering Work Group. He is certified by the National Association of Certified Valuation Analysts (NACVA), and holds that organization's highest designation as a Certified Valuation Analyst (CVA). He is accredited as a Certified Fraud Examiner (CFE). In addition, Michael is an Accredited Senior Appraiser of the American Society of Appraisers (ASA).

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