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Exelon Corp. v. Commissioner
Expert independence: Interfere at your own risk

Adjusting owners' compensation in business valuation

How do valuations and calculations differ?

Harness the power of social media in litigation

Exelon Corp. v. Commissioner

Expert independence: Interfere at your own risk

Professional standards require valuation experts to perform assignments with impartiality, objectivity and independence. The U.S. Tax Court's opinion in *Exelon Corp. v. Commissioner* serves as a cautionary tale for attorneys who would seek to influence an expert's conclusions. The court found that a law firm's interference in the valuation process tainted the expert's opinion and rendered it "useless."

Section 1031 exchange strategy

In 1999, Exelon sold its fossil fuel power plants, generating $1.6 billion in taxable gain. To minimize the tax blow, the company employed a complex "like-kind" exchange strategy. Under Internal Revenue Code Section 1031, taxpayers are allowed to defer gain by exchanging certain relinquished properties for one or more like-kind replacement properties.

Exelon used the proceeds from the sale of its fossil fuel plants to invest in several sale-leaseback transactions involving power plants owned by tax-exempt public utilities in different states. Exelon leased the power plants from these third parties for terms that exceeded the plants' useful lives, and then subleased them back to the public utility companies (the sublessees). At the end of the subleases, the sublessees had cancellation/purchase options that allowed them to buy back their properties.

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Treatment of these transactions as like-kind exchanges provided Exelon with significant tax benefits: In addition to deferral of its taxable gain, the taxpayer enjoyed various tax deductions as owner of the replacement properties.

Valuation issues

Exelon retained a law firm to advise it on the legal aspects of the transactions and to provide opinions on the tax consequences. The taxpayer also hired a large national accounting firm to value the relinquished properties and potential replacement properties.

The lynchpin of Exelon's tax strategy was the fair market value of the replacement properties at the end of the sublease term. If the replacement properties were worth *less* than the buyback price, the public utility companies wouldn't be economically

Use of experts doesn't safeguard against penalties

Internal Revenue Code Sec. 6662 imposes a 20% accuracy-related penalty on the portion of a tax underpayment attributable to negligence or disregard of rules and regulations, or a substantial understatement of income tax. The penalty doesn't apply, however, to any portion of an underpayment for which a taxpayer had reasonable cause and acted in good faith.

One way to establish this defense is to demonstrate reasonable, good faith reliance on advice from a competent tax professional. In *Exelon*, the Tax Court rejected this defense, ruling in favor of more than $87 million in accuracy-related penalties against Exelon.

Given the taxpayer's level of sophistication, the court explained, it "knew or should have known that the conclusions in the tax opinions were inconsistent with the terms of the deal." The court refused to condone the use of a tax opinion as "an insurance policy against penalties," when the taxpayer knew or should have known that the opinion was flawed.

compelled to exercise their options. Thus, the transactions would qualify as equity investments rather than loans or other financial arrangements.

The IRS issued a notice of deficiency for nearly $437 million in income taxes plus 20% accuracy-related penalties totaling more than $87 million. The IRS argued that Exelon didn't satisfy the requirements of Sec. 1031, because it failed to "acquire and retain significant and genuine attributes of a traditional owner, including the benefits and burdens of ownership, of the [replacement property]."

Unreliable opinions

The Tax Court sided with the IRS, finding the transactions more akin to loans than equity investments. The court cited the testimony of an IRS expert who identified several flaws in Exelon's valuations, including reliance on unreasonably high tax and discount rates. The expert estimated that the value of the plants at the end of the subleases would be substantially *higher* than the exercise price of the buyback option, making it "nearly certain" that the utility companies would exercise their options. As a result, Exelon's investment lacked "an upside potential or significant downside risks."

The court opinion emphasized that the law firm had undermined the reliability of Exelon's expert opinions by interfering with the integrity and independence of the valuation process. The firm sent the accounting firm a letter listing "appraisal conclusions we anticipate will be necessary to support our tax opinion," which appeared almost verbatim in the expert's reports. And it provided "continuous and substantial feedback" on draft valuation reports.

The law firm didn't explicitly direct the expert to arrive at a specific fair market value for each replacement property. But the accounting firm knew, from its valuations of the plants Exelon sold, how much gain Exelon sought to defer.

The court also upheld the $87 million in accuracy-related penalties. Exelon asserted its reliance on professional tax advice as a defense, but the court found that reliance to be "misguided." (See "Use of experts doesn't safeguard against penalties" above.)

Handle with care

Exelon illustrates the importance of respecting the objectivity of valuation professionals. Even the perception that an expert's independence has been compromised can be devastating to your case. ■

Adjusting owners' compensation in business valuation

It's common for owners of privately held businesses to over- or underpay themselves for a variety of reasons. When valuing a controlling interest under either scenario, it may be necessary to adjust (or "normalize") owners' compensation to reflect the amount that an unrelated third party would receive for performing similar duties. Here are some factors that valuation experts consider when making this adjustment.

How much are the owners' contributions worth?

A common approach to estimating replacement compensation is to start at a micro-level and work up from there. At the most basic level, the expert writes up an accurate job description, keeping in mind that many existing job descriptions are inaccurate or outdated. He or she should also list the educational and work history prerequisites a replacement candidate should possess. If the owner has advanced education or other qualifications that are unrelated to his or her responsibilities (such as an architect with a law degree), the additional qualifications typically aren't factored into the estimate of replacement compensation.

> *When evaluating the industry, it's important to research external compensation studies and to interview recruiters.*

Next, the expert considers the company's characteristics. Healthy companies — those with high growth and profits — tend to pay employees more than financially distressed entities. The expert will also consider the company's size in terms of sales and market share. Although larger companies tend to pay more than their smaller counterparts, some smaller companies must pay a premium to persuade key employees to leave competitors (and to retain them once they leave).

No estimate of replacement compensation would be complete without an evaluation of the industry's trends. Industry research can help an expert understand how much competition exists and its typical methods of compensation, including base salaries, bonuses, commissions, benefits and stock options. If the industry is cyclical, he or she needs to find out whether it's currently at a peak, a trough, or somewhere in between. When evaluating the industry, it's important to research external compensation studies and to interview recruiters.

Finally, the expert must consider the state of the economy. He or she starts with local economic conditions, such as the cost of living at the company's location. A replacement would be paid less if the company were located in Manhattan, Montana, than if it were located in Manhattan, New York. The national economy is also important. For instance, people are generally paid less in a recession — when profits are down, cash is tight and jobs are hard to come by — than when the economy is booming.

When do compensation issues arise?

The term "reasonable compensation" is rooted in tax law. Why? Historically, some C corporation owners have tried to pay themselves exorbitant

salaries — in lieu of dividends — to get cash out while simultaneously lowering the company's tax bill. So, the IRS often audits companies with high owners' salaries and doles out penalties on any salary in excess of what the IRS deems reasonable.

This issue also crops up in divorce cases. But, rather than overpay their salaries, business owner spouses have the opposite agenda: To reduce maintenance payments to their spouses, business owner spouses may try to *understate* compensation. Therefore, the U.S. Tax Court cases involving reasonable compensation may not be particularly helpful in divorce cases.

Likewise, the owner of a start-up or a struggling business might take a minimal salary to preserve a cash flow. Conversely, some owners treat the corporate bank account as their personal piggy bank. Other business owners overpay themselves, because they have unrealistic opinions of their day-to-day contributions to their companies.

Regardless of whether the expert adjusts compensation up or down, it's important to remember to adjust the company's income stream for compensation-related items, such as payroll tax expense, benefits and other perks.

A word of caution

Virtually every business owner who's under oath will say that his or her compensation is "reasonable." But reasonableness is in the eye of the beholder. So, when broaching the subject, many valuation experts prefer to use the term "replacement compensation," which is likely to trigger fewer emotional responses and unwanted attention from the IRS. ■

How do valuations and calculations differ?

Most business valuation professional standards recognize two types of engagements: calculations and valuations. But in most litigation contexts — particularly when the business valuation professional will testify as an expert witness — only a full valuation report will suffice.

Conclusion of value vs. calculation of value

Valuation professionals follow different standards, depending on the organizations with which they're affiliated. Although these standards vary somewhat, they generally concur on the amount of research and analysis required to prepare a full valuation. In a calculation engagement, however, the standards allow an expert to rely on specific (limited) information, analytical procedures and techniques to arrive at a calculation of value.

So, the critical distinction between the two types of engagement is the extent to which the valuation professional exercises professional judgment. In a valuation, the expert considers all relevant information, procedures and methods, and then chooses the methods he or she deems appropriate to arrive at a *conclusion* of value.

But, in a calculation, the expert and client agree in advance on the scope, information, procedures and methods that can be used. For example, the parties might agree that the expert won't visit the company's facilities or interview management. Or they might decide that the expert will perform a discounted cash flow analysis but won't research comparable transactions.

Therefore, a calculation engagement doesn't result in a value *conclusion* — it results in a value *calculation*. And it's common for calculation reports to qualify the expert's findings by stating that the results might have been different had a full valuation been performed.

Purpose of the engagement

A calculation engagement can be a cost-effective planning tool for, say, early-stage litigation, expansion projects, out-of-court settlements or M&A negotiations. But a full valuation report is usually called for when it appears that a matter is headed for trial or a third party will rely on the valuation expert's fair market value conclusion.

Courts traditionally give little weight to valuation testimony if the expert was engaged to perform only a calculation of value. But that doesn't necessarily mean that such testimony is *inadmissible*.

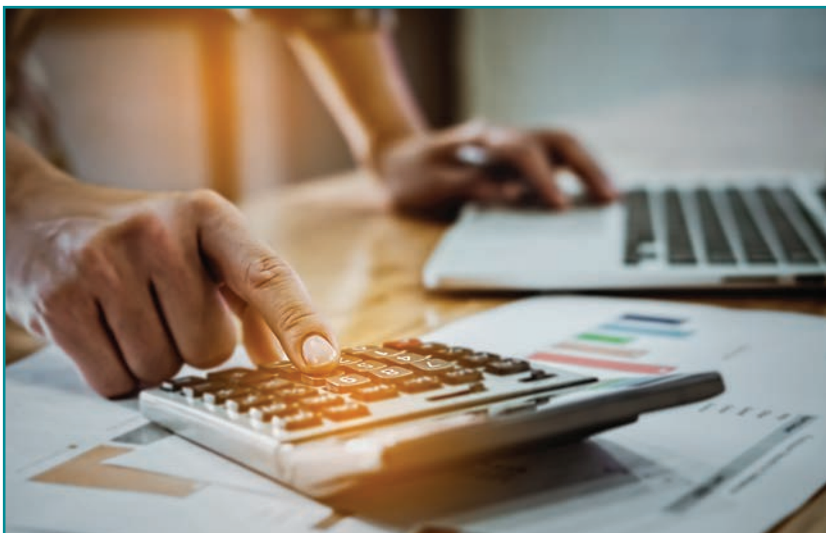
For example, in *Hipple v. SCIX*, a federal district court permitted an expert to testify, even though he provided only a value calculation, not a value conclusion. In this *Daubert* challenge, the defendants questioned the opposing expert's conclusions on reliability and relevance grounds. The court denied the motion, noting that:

1. The expert was a CPA, and the American Institute of Certified Public Accountants (AICPA) approves of both calculations and conclusions of value,
2. The expert explained that he couldn't provide a value conclusion because he had only limited information about the defendants' financial records, and
3. The expert made his assumptions and methodology clear.

Under those circumstances, it was appropriate for the trial court to admit the expert's opinion and determine the weight to give the expert's testimony after cross-examination.

It's common for calculation reports to qualify the expert's findings by stating that the results might have been different had a full valuation been performed.

Even if a calculation of value is admissible, however, it's unlikely to be given much weight. For example, in *Surgem, LLC v. Seitz*, the appellate court upheld the trial court's rejection of an expert's testimony based on a calculation of value. The expert testified that "more work should have been done" for him to develop a value conclusion and prepare a full valuation report.



Calculations offer limited value

Calculation engagements have their place. But, when you go to court, your expert generally needs a full valuation report. Even if a calculation is admissible, its limitations will likely diminish its probative value. ■

Harness the power of social media in litigation

A wealth of information is stored on social media sites — including Facebook, LinkedIn, Twitter, Instagram and Pinterest — making them excellent sources of evidence. Examples of the myriad ways that social media can be used in litigation include:

Uncovering hidden assets. Parties may try to hide assets in a variety of contexts, including fraud investigations, shareholder disputes and marital dissolution cases. Social media posts may reveal the existence and whereabouts of hidden assets.

For example, a divorcing spouse might post a photo of a new luxury car or vacation home. Or a business might advertise the grand opening of a new location on Facebook while the controlling shareholder testifies in court that the business is struggling.

Calculating damages. Suppose one company sues another for patent infringement, claiming lost profits damages. However, a review of social media posts might reveal numerous customer complaints about defects in the plaintiff's products. These posts might suggest an alternative explanation for its financial losses that's unrelated to the defendant's alleged infringement.

Establishing securities law violations. Social media can form the basis of a fraudulent misrepresentation claim. For example, an investment firm might brag on Twitter or Facebook that it can double or triple your initial investment.

Likewise, social media sources may reveal potential violation of Regulation Fair Disclosure (FD), which prohibits public companies from providing certain individuals or entities, such as securities analysts or institutional investors, with important nonpublic information before sharing the information with the general public.

For example, in 2012, Netflix's CEO posted a message to his personal Facebook page congratulating his team on surpassing 1 billion hours in monthly viewing. This post violated Reg FD because the company failed to simultaneously announce the achievement through public channels.

Locating individuals. A person may "check in" at a restaurant on Facebook or post a photo that contains embedded location data. This information can be useful in serving process or contacting potential witnesses. It may also be used to disprove a party's claim that he or she was in a particular place at a particular time.

Revealing feigned injuries. Social media can be a great way to catch a party engaged in activities that belie the seriousness of his or her injuries. For example, an injured party might be tagged in a Facebook post showing her dancing or rock climbing with friends the week after a work-related accident.

As these examples demonstrate, social media evidence can be an indispensable part of the litigation process. But exercise caution: Gathering social media also raises a variety of discovery challenges involving privacy, authenticity and reliability. ■

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