Tax court: Subsequent events can affect fair market value

Should a valuation take into account an event that occurred after the valuation date? Most attorneys would probably answer with an emphatic "no," but the Tax Court has ruled otherwise. In Estate of Noble v. Commissioner, T.C. Memo. 2005-2 (2005), the court allowed a post-death occurrence to affect the value of the decedent's stock shares.

Setting the stage

Lacking the benefit of the listed market prices of publicly traded stock, CPAs valuing the stock of privately held companies must first examine any arm's-length sales of stock that occurred near the valuation date. The taxpayer in Noble argued that only sales made prior to the valuation date were relevant. It asserted that such sales conclusively set the fair market value (FMV) even if the seller lacked knowledge of all pertinent facts related to the property and the property sold wasn't comparable to the subject property in size.

In the case at hand, Helen Noble owned 116 of the 1,000 shares in Glenwood State Bank at her death. Glenwood Bancorporation owned the remaining shares. During the 15-month period preceding Noble's death, Bancorporation purchased a block of 10 shares and another block of seven shares, for $1,000 and $1,500 per share, respectively. The estate argued that a valuation of Noble's shares should consider only these two sales.

The IRS, however, noted that a post-death appraisal, conducted for a potential sale of Noble's shares, valued the stock at $7,569 per share. Further, 14 months after her death, the estate sold the shares for $9,483 per share.

Looking beyond the grave

The court disagreed with the estate's claim that the two pre-death sales provided "an accurate measure" of the FMV of Noble's shares. It also was unpersuaded that either of those sales were made at arm's length or by a knowledgeable seller who wasn't compelled to sell, noting that the sellers failed to sell their shares for an amount established by the appraisal. And, at the time of Noble's death, her shares were the only outstanding shares not owned by Bancorporation; the shares therefore took on a "special value" a hypothetical seller would have recognized.

The court also dismissed the taxpayer's overarching argument that only sales completed prior to the valuation date were relevant. It acknowledged that the general rule calls for valuing property without regard to subsequent events but stated that "an event occurring after a valuation date … is not

necessarily irrelevant to a determination of fair market value as of that earlier date." The court held that subsequent events could affect the FMV on the valuation date if they were reasonably foreseeable as of that date.

According to the Tax Court, even if an event wasn't foreseeable, it can prove probative to the extent it is relevant to establishing the amount a hypothetical buyer would have paid a hypothetical seller. The court explained that this category of subsequent events includes evidence of "actual sales prices received for property after the date, so long as the sale occurred within a reasonable time … and no intervening events drastically changed the value of the property."

Making necessary adjustments

The Tax Court did grant that, when a subsequent sale is used to set FMV, adjustments must be made to account for the passage of time and any change in the setting from the date of valuation to the date of sale. The adjustments should reflect "happenings" that would affect the later sale price, including:

- Inflation,
- Changes in the relevant industry and the expectations for that industry,
- Changes in business component results,
- Changes in tax law, macroeconomics, or technology, and
- The occurrence or nonoccurrence of any event which a hypothetical reasonable buyer or seller would conclude could affect the selling price of the property subject to valuation — for example, the death of a key employee.

In Noble, the court found no material change in circumstances and adjusted only for inflation.

Considering the FMV effect

While it noted the limited evidentiary record in this case, the Tax Court held that the post-death sale of Noble's stock offered the "best indicium" of its FMV. The bottom line is that subsequent events might come into consideration in a valuation case, so financial experts should strive to develop value-related evidence based on actual market conditions. With sufficient evidence, they can minimize the negative impact of subsequent events.❖

Little things add up

Uncovering and prosecuting expense account fraud

Expense account fraud has become one of the most common types of white-collar crime, comprising 12% of all corporate fraud cases, according to the Association of Certified Fraud Examiners (ACFE). When it goes undetected and unprosecuted, it can have a ripple effect, leading to more significant misconduct, such as falsifying financial statements.

Forensic accountants can help find telltale signs of expense account abuse and track down evidence of fraudulent transactions.

Methods of manipulation

According to the ACFE, employees who abuse their expense accounts generally use one of four methods:

Mischaracterized expenses — producing legitimate documentation for non-business-related transactions, such as taking friends to dinner and reporting it as "business development,"

Overstated expenses — inflating the amount of actual expenses and pocketing the difference,

Fictitious expenses — submitting phony documentation for reimbursement, and

Multiple reimbursements — copying invoices and submitting them for payment more than once.

Of course, some employees may engage in more than one method. If successful, they may become chronic abusers.

Because the amounts submitted for reimbursement are relatively small, expense account fraud often goes on for several years before discovery. But forensic accountants can expedite the detection process by identifying employees who submit expense reports that are disproportionate to those of their co-workers in similar positions. Employees who submit significantly larger claims may be submitting fictitious expenses. Fraud experts will also pay greater attention to expense reports that consistently include an abundance of items that fall just short of limits for undocumented claims.

Common areas of abuse

Forensic accountants who suspect expense account fraud scrutinize several areas especially ripe for fraud:

Taxicab fares. Most cab drivers provide passengers with blank receipts, so employees can easily complete them to reflect a greater fare than actually paid. Some employees hoard blank cab receipts, saving them to submit for reimbursement at a later date when they've actually used public transportation or reduced-fare shuttles.

Rental cars. Employees may also alter the receipts they receive from rental car companies.

Mileage. Employees may claim a trip was farther than it actually was, or seek reimbursement for miles accrued during nonbusiness travel.

Air travel. Employees expected to front the costs of an airline ticket may claim that only first-class tickets were available yet actually purchase both a coach fare and first-class ticket. The employees can use the coach ticket on the trip while seeking reimbursement for the higher priced fare and subsequently cash in the first-class ticket or obtain credit.

Entertainment. Employees may alter receipts, submit personal expenses as business-related expenses or submit receipts from closed or phony businesses.

Lodging. Employees sometimes stay in a low-priced hotel but submit a reimbursement request for a pricier one. Or employees might return from a trip a day early and then seek reimbursement for the extra night.

Finding evidence

Forensic experts often uncover expense account schemes by scrutinizing employee documentation for inconsistencies and anomalies. They expect to find information that reinforces employees' assertions they were in a certain location on a certain day. An employee who submits a claim for a flight that arrived in Chicago on July 1, for example, should submit corresponding claims for meals, taxi fares or lodging in Chicago on or close to that date. But employee time records might reveal that the employee was, in fact, in a different location at the time.

Fraud experts also will examine the physical nature of the employee's documentation. The level of detail on today's receipts far exceeds yesterday's blank check stubs that allowed employees to scribble in their own amounts. Most receipts are now time- and date-stamped, requiring unethical employees to tamper with them. A receipt with a clean edge at its top but a serrated bottom edge could indicate tampering and warrants additional investigation.

Covering the bases

In times of shrinking raises and disappearing bonuses, some employees may feel entitled to pad their expense accounts. When successful, these schemes can rob companies of thousands, even millions, of dollars a year and foster a corporate environment that tacitly encourages other, more serious forms of fraud. So it's critical to uncover expense account fraud, including sufficient evidence to prosecute the perpetrator — or at least support a termination.

Sidebar: Building the case

When litigation is anticipated, forensic accountants ensure that all evidence — physical and documentary — is properly gathered and maintains a chain of custody. Absent a confession, an expert will assemble the evidence in a factual format for presentation to the fact finder. Evidence is typically presented graphically in a logical time sequence order, often using software programs for optimal visual impact. ❖

Making the antitrust case

CPAs provide evidence that holds up in court

More than 100 years after Congress passed the Sherman Act, courts continue to weigh antitrust allegations. Antitrust cases generally involve complicated liability and damages issues, calling for detailed analyses by financial experts of factors like markets, industry conditions, market power, the likelihood of new entry and causation.

Laying out liability

CPAs can be especially valuable in determining if the defendant engaged in predatory pricing — selling its product at artificially low prices with the intention of driving its competitors out of the market. The fact that a defendant went from enjoying profits to sustaining losses alone doesn't answer the issue; the defendant may offer a reasonable explanation for the shift, such as an effort to better compete with other firms. The critical question lies in whether the price was above the defendant's average variable costs.

Reaching a figure for the average variable costs requires more than merely lifting numbers from the defendant's ledger accounts. These accounts typically use functional classifications for costs, and the classifications can prove misleading for cost behavior purposes. Instead, experts conduct a comprehensive cost behavior analysis. They categorize costs as fixed, variable or mixed and then examine the behavior of each category.

Several tools are available for studying cost behaviors, including regression and correlation analyses. These analyses measure the nature and strength of the relationship between two variables, such as cost and sales or cost and production rates. It's rare to find a perfect correlation between two variables because actual cost data usually doesn't segregate costs by fixed, variable or comparable characteristics. The standard of error reflects the variability of the cost data — the greater the standard of error, the greater the variability and the less reliable the resulting estimates.

Bear in mind that regression and correlation analyses show only the degree of association; they don't establish causation. Attorneys shouldn't point to variables that move in the same direction as proof that one variable caused the other. Additional evidence must be considered to support causation. CPAs look at the effect of cost allocations and timing, transfer prices within the business, and the business's accounting policies.

Determining damages

A section of the Reference Manual on Scientific Evidence used by federal judges addresses the estimation of antitrust damages, highlighting the importance of qualified expert testimony on several issues.

When it comes to the scope of damages, for example, the manual notes that a plaintiff might calculate the damages affecting all of its business activities. The defendant, on the other hand, will likely calculate damages based on only the markets that will likely suffer an adverse impact because of misconduct.

The manual also states that establishing a causal link between the defendant's misconduct and damages necessitates a "complete analysis of the economic impact of the antitrust misconduct on the relevant market." It specifies that regression analysis might adjust for economic influences other than the misconduct, including the national price level, the gross domestic product and variables specific to the industry.

Deferring to Daubert

Courts have increasingly used the Supreme Court decision in Daubert v. Merrill Dow to exclude unreliable economic testimony in antitrust cases. The rulings make clear that judges expect more than just certifications and scholarly papers.

Expert testimony is most likely to be included by the court when the expert has: gathered or used relevant and actual market data; regarded alternative theories and explanations for market conditions; and adequately defined critical factors, such as the relevant market. ❖