

ble to the CPA's work. In addition, the CPA should be aware of what has happened in the courtroom before providing expert testimony. The more the CPA knows about who will be listening to the testimony, the more effective he or she will be.

KNOW THE ADVERSARY

The CPA should know the adversary as well. All parties and important witnesses should be considered in the conflict of interest procedures to ensure that the CPA is not taking the witness stand against a current client and that no important adverse witnesses are clients of the firm.

The more the CPA knows about the adversary—even information that is not absolutely necessary—and understands the context of the questioning, the better able he or she will be to deal with cross-examination.

The rules of many courts require the expert to file a statement of his or her qualifications before trial, along with a summary of testimony. The CPA should read this statement carefully to ensure it is accurate. Taking this step will prevent an awkward moment if a significant inaccuracy is first discovered during cross-examination in front of a judge, jury, and client. Even worse, the client could use it later as a misrepresentation in a suit against the expert.

DOCUMENTATION

As the case proceeds, the CPA needs to use care in what he or she puts in writing. Although a consultant's work product is not usually open to discovery, an expert's work product is—and it's not uncommon for the CPA to perform both functions. In this regard, the CPA needs to understand when

Dual Insurance Perspective


Providers of professional liability insurance for CPAs, such as DPIC Companies, have a dual perspective on the CPA's role as an expert witness. They provide coverage for a CPA's activities as expert witness, mediator, or arbitrator and also retain CPAs to assist in litigation as part of their claims-handling activities on behalf of their policyholders.

The characteristics these providers look for when selecting expert witnesses include the following:

- ▲ **Credentials, experience, technical knowledge.** This includes knowledge not only of accounting-related issues but also of the legal processes and industry specialization, including the insurance industry.
- ▲ **Ability to communicate complex ideas clearly and convincingly.**
- ▲ **An ethical, professional, objective demeanor.**
- ▲ **Ability to stand up to pressure and maintain composure on the witness stand.**
- ▲ **Professional liability insurance.** The professional must carry adequate limits of professional liability insurance.
- ▲ **Ability to get along with the policyholder.**

DPIC, for example, selects experts with the input of policyholders. The policyholder has a large stake in the outcome, so it is important to have counsel, advisors, and experts in whom the policyholder has trust and confidence. There is also a sensitivity, particularly for a CPA client, regarding who will be "looking into their dirty laundry." They certainly don't want it to be a competitor CPA.

his or her role has changed from consultant to expert witness.

The CPA can prepare to present testimony by imagining how the important points of testimony can be brought out, how the lawyer for the adversary will attack the testimony on cross-examination, and how the testimony will sound to a juror. 



**BUILT-IN GAIN VALUATION ADJUSTMENT:
NO LONGER "IF" — BUT "HOW" AND
"HOW MUCH"**



John R. Gilbert, CPA/ABV, CVA

CPAs are accustomed to advising clients on buying and selling businesses. "Buy assets, sell stock" has long been our mantra in planning business transactions for clients. Before pas-

sage of the Tax Reform Act of 1986 (TRA86), the *General Utilities* doctrine (*General Utilities & Operating Co. v. Helvering*, 16 AFTR 1126) allowed C corporations to distribute appreci-

Table 1 — Assumptions

Total Fair Market Value of Asset(s)	\$100,000
Additional Amount of Asset(s) Value Which Would be Depreciable	\$50,000
Existing Corporate Tax Basis of Asset(s) (Non Depreciable Amount)	\$10,000
Depreciable Life In Years	30
Compound Annual Growth Rate of Asset(s) Value	6%
Pre-Tax Return on Reinvested Tax Savings	6%
Corporate Tax Rate	40%
Individual Income Tax Rate for Depreciation Recapture	25%
Individual Income Tax Rate	40%
Individual Capital Gains Rate	20%

ated assets to shareholders without recognizing a gain. After the repeal of *General Utilities* by TRA86, C corporations no longer could distribute those appreciated assets without an additional tax at the corporate level. Buying appreciated assets inside a C corporation has imposed a terrible penalty on the purchaser.

CPAs have been advising buyers that the built-in gain tax on a C corporation reduces the fair market value of the corporation stock. At the same time, they have been appraising businesses for estate and gift purposes knowing the IRS refused to officially recognize the impact on value of this built-in gain. The IRS's position has been that, unless a liquidation of the corporation is planned, the tax is "speculative" and therefore should not be recognized. Two recent decisions—the Tax Court decision in *Estate of Artemus Davis*, 110 T.C. 35 and the U.S. Second Court of Appeals decision in *Irene Eisenberg v. Commissioner*, 82 AFTR2d Par. 98-5173—have changed the question from whether the tax impact should be considered to how to reflect the discount in the valuation and how much of a discount is appropriate.

THE DAVIS DECISION

The *Davis* case is an estate tax case in which the appreciated underlying assets were in large part shares of Winn-Dixie Stores Inc. publicly traded common stock. The Tax Court allowed the adjustment for the built-in gain tax as a 15-percent addition to the marketability discount. In this case, three well-qualified valuation experts supported a discount for the built-in gain tax. The most logical of the three approaches was that of the expert who supported simply recording

the tax on the built-in gain as a liability on the fair market value balance sheet. The other taxpayer expert and the IRS expert both concluded that the adjustment for the built-in gain tax should be recognized as an addition to the marketability discount. Fortunately for the appraisal community, the case went to trial but, unfortunately, the Tax Court adopted the marketability adjustment approach.

THE EISENBERG RULING

The *Eisenberg* case is a gift tax case in which the underlying asset was appreciated commercial real estate. The taxpayer had been deducting the built-in gain tax from the appreciated asset value in making gifts and the Tax Court disallowed this adjustment. The U.S. Second Court of Appeals overturned the Tax Court on this issue and remanded the case for determination of the built-in gain tax adjustment. The Tax Court has yet to rule on the remanded case. Some of the comments from the footnotes to the Second Circuit ruling are worth noting:

One might conclude from this example that the full amount of the potential capital gains tax should be subtracted from what would otherwise be the fair market value of the real estate. This would not be a correct conclusion.

Where there is a relatively sizable number of potential buyers who can avoid or defer the tax, the fair market value of the shares might well approach the pre-tax market value of the real estate. Potential buyers who could avoid or defer the tax would compete to purchase the shares, albeit in a market that would include similar real estate that was not owned by a corporation. However, where the number of potential buyers who can avoid or defer the tax is small, the fair market value of the shares might be only slightly above the value of the real estate net of taxes. In any event, all of these circumstances should be determined as a question of valuation for tax purposes.

Although these decisions clearly support a reduction in value for the tax on built-in gain, they, unfortunately, do not indicate clearly how best to quantify and reflect this adjustment. No empirical data support any level of adjustment to the marketability dis-

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Table 2 — Rates of Return

1. Property purchased directly and held outside of corporate entity

ASSUME SOLD AT END OF YEAR	0	1	2	3	4	5	10	15	20	25	30
Amount paid by buyer	\$100,000										
Cumulative value of asset(s)	\$106,000	\$112,360	\$119,102	\$126,248	\$133,823	\$179,085	\$239,656	\$320,714	\$429,188	\$574,349	
Future value of tax savings on additional depreciation	667	1,373	2,122	2,916	3,758	8,787	15,517	24,524	36,576	52,705	
Recapture additional depreciation	(417)	(833)	(1,250)	(1,667)	(2,083)	(4,167)	(6,250)	(8,333)	(10,417)	(12,500)	
Capital gains tax	(1,200)	(2,472)	(3,820)	(5,250)	(6,765)	(15,817)	(27,931)	(44,143)	(65,838)	(94,870)	
After-tax cash to buyer	<u>\$105,050</u>	<u>\$110,428</u>	<u>\$116,154</u>	<u>\$122,247</u>	<u>\$128,733</u>	<u>\$167,888</u>	<u>\$220,992</u>	<u>\$292,762</u>	<u>\$389,509</u>	<u>\$519,684</u>	
Compound annual growth rate	5.05%	5.08%	5.12%	5.15%	5.18%	5.32%	5.43%	5.52%	5.59%	5.65%	

2. IRS Position—Stock purchase with no reduction in price paid for built-in gain tax, property remains in corporation

ASSUME SOLD AT END OF YEAR	0	1	2	3	4	5	10	15	20	25	30
Amount paid by buyer	\$100,000										
Cumulative value of asset(s)	\$106,000	\$112,360	\$119,102	\$126,248	\$133,823	\$179,085	\$239,656	\$320,714	\$429,188	\$574,349	
Corporate tax	(38,400)	(40,944)	(43,641)	(46,499)	(49,529)	(67,634)	(91,862)	(124,286)	(167,675)	(225,740)	
Gross cash to shareholder	67,600	71,416	75,461	79,749	84,294	111,451	147,794	196,428	261,513	348,609	
Individual (tax)/savings	6,480	5,717	4,908	4,050	3,141	(2,290)	(9,559)	(19,286)	(32,303)	(49,722)	
After-tax cash to shareholder	<u>\$74,080</u>	<u>\$77,133</u>	<u>\$80,369</u>	<u>\$83,799</u>	<u>\$87,435</u>	<u>\$109,161</u>	<u>\$138,235</u>	<u>\$177,142</u>	<u>\$229,210</u>	<u>\$298,887</u>	
Compound annual growth rate	-25.92%	-12.17%	-7.03%	-4.32%	-2.65%	0.88%	2.18%	2.90%	3.37%	3.72%	

3. Stock purchase with \$ for \$ price reduction for built-in gain tax, property remains in corporation

ASSUME SOLD AT END OF YEAR	0	1	2	3	4	5	10	15	20	25	30
Amount paid by buyer	\$64,000										
Cumulative value of asset(s)	\$106,000	\$112,360	\$119,102	\$126,248	\$133,823	\$179,085	\$239,656	\$320,714	\$429,188	\$574,349	
Corporate tax	(38,400)	(40,944)	(43,641)	(46,499)	(49,529)	(67,634)	(91,862)	(124,286)	(167,675)	(225,740)	
Gross cash to shareholder	67,600	71,416	75,461	79,749	84,294	111,451	147,794	196,428	261,513	348,609	
Individual tax	(720)	(1,483)	(2,292)	(3,150)	(4,059)	(9,490)	(18,759)	(26,486)	(39,503)	(56,922)	
After-tax cash to shareholder	<u>\$66,880</u>	<u>\$69,933</u>	<u>\$73,169</u>	<u>\$76,599</u>	<u>\$80,235</u>	<u>\$101,961</u>	<u>\$131,035</u>	<u>\$169,942</u>	<u>\$222,010</u>	<u>\$291,687</u>	
Compound annual growth rate	4.50%	4.53%	4.56%	4.59%	4.63%	4.77%	4.89%	5.00%	5.10%	5.19%	

count for built-in gain taxes. The proper way to deal with the discount is to reflect it as a liability on the fair market value balance sheet. Further, as demonstrated below, the proper amount of the discount is the full amount of the tax liability.

DETERMINING RATES OF RETURN

Tables 1 and 2, pages 8 and 9, set forth both the assumptions used and the resulting rates of return that would be earned by a hypothetical purchaser. Table 1 lists the assumptions used for the calculations under the purchase scenarios in table 2. Table 2 sets forth three purchase scenarios and shows the rate of return a buyer would earn under each scenario. This analysis is similar to one done recently by Z. Christopher Mercer of Mercer Capital (Nashville, Tennessee) in "Imbedded Capital Gains in C Corporation Holding Companies," *Valuation Strategies* November/December 1998. Although the

two analyses were done independently with slightly different assumptions, both arrive at virtually identical returns.

Under the first scenario, the assets are purchased outright at fair market value and are held outside of corporate ownership. Under the second scenario, C corporation stock is purchased for the fair market value of the underlying assets with no adjustment for the tax liability on built-in gain. This is the IRS position in *Davis and Eisenberg*. Under the final scenario, the purchase price of C corporation stock is reduced for the tax on the built-in gain, but the corporation continues as the owner of the assets. As is seen in table 2, the IRS position assumes a hypothetical willing purchaser who is willing to accept a subnormal return, even thirty years hence. The first and third scenarios are approximately equal but still show the disadvantage of holding appreciating assets inside a C corporation.

CONCLUSION

A straightforward analysis of rates of return shows that a hypothetical willing buyer who is a rational investor seeking to maximize returns will discount the stock of a C corporation to adjust for the impact of income tax on the built-in gain. I plan to incorporate the table 2 analysis, using actual amounts, in

future appraisal reports claiming a reduction in value for taxes on built-in gain. **CE**

Author's note: Readers who wish to comment on this article or would like a copy of the spreadsheet used to develop the rates of return can e-mail jgilbert@micpas.com. Copies are available only by e-mail in Microsoft Excel format.



CALCULATING LOSS FROM PERSONAL INJURY, WRONGFUL DEATH, AND EMPLOYMENT DISCRIMINATION

The Role of the CPA

Holly Sharp, CPA, CFP, CFE

Litigation services that CPAs provide to their clients may include the calculation of damages from personal injury, wrongful death, and employment discrimination. The CPA is an ideal expert to perform this calculation, which usually involves quantifying the net monetary losses sustained by the claimant and presenting findings to a trier of fact.

Although this service has historically been provided primarily by economists, CPAs are being called upon more frequently to perform the calculation, render reports, and testify in court in these litigation matters. By virtue of their education, training, and experience, CPAs are the ideal experts to calculate damages.

THE ISSUES INVOLVED

In cases involving the calculation of loss from personal injury, wrongful death, and employment discrimination, monetary losses may include wages, fringe benefits, rents, royalties, investment income, household services, and medical costs. The date of injury, death, or discrimination incident generally establishes the beginning of the loss period, and the loss extends through worklife (worklife expectancy), life (life expectancy), or another loss period, depending on the facts of the case.

In the damages calculation, the CPA analyzes the following four general issues, although other issues may be relevant,

depending on the facts of the case:

What types of losses have been incurred?

- ▲ Wages
- ▲ Fringe benefits
- ▲ Other income
- ▲ Household services
- ▲ Medical costs

Over what period have these amounts been lost?

- ▲ Worklife expectancy
- ▲ Life expectancy
- ▲ Date of employment

What growth rate would apply to elements of loss during the loss period?

What rate should be used to discount amounts to the date of trial?

WHY THE CPA IS EXPERT

The CPA's knowledge of compensation issues from preparing tax returns and providing accounting services to individuals and businesses forms the basis to establish the amount of losses. The CPA's experience with varied industries helps in determining the applicable fringe benefits and the rate of growth of wages and benefits. The CPA is used to analyzing historical financial and economic data, including surveys and studies, and is familiar with the use of statistics and sampling to evaluate the reliability of such data. Knowledge of income tax rules and regulations assists the CPA in calculating wage loss on an after-tax basis. The CPA understands the concepts required to

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