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# Valuation & Litigation

BRIEFING

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# Clues abound

## The tax return as an investigative tool

**T**ax returns can be a highly effective investigative tool in fraud and divorce cases, shareholder litigation, and other situations in which a defendant may have hidden assets. In fact, virtually every page of a tax return can provide clues to hidden assets.

And examining several years' worth of returns can uncover telling trends. For example, interest or dividend income in 2009 may reveal little, but significantly higher numbers for 2008 may indicate that the taxpayer sold stocks or other investments. Following the proceeds may lead to undisclosed assets.

### Revealing trends in the 1040

A forensic accountant starts the search for undisclosed assets with the taxpayer's Social Security number and other personal information in the Form 1040.

Reviewing several years' returns can reveal previous addresses and names as well as other avenues of investigation. The expert also reviews:

*Tracing mortgage interest to specific properties can lead to undisclosed real estate. If a mortgage has been refinanced, the expert will determine whether the taxpayer received any cash and, if so, trace the proceeds.*

**Income from wages.** Using this information, the expert can determine if wage income is derived from

multiple sources that may lead to undisclosed business interests. W-2 forms may reveal the existence of unknown retirement plans or other benefits.

**Interest and dividends.** Here the issue is underlying assets. If the amount of taxable interest or ordinary dividends exceeds \$1,500, the taxpayer is required to provide additional details on Schedule B. But even if the amount of interest and dividends is small, the underlying assets may be significant.

Tax-exempt interest is shown (but not taxable) on Form 1040 and may be reported on some state income tax returns. So the expert will likely look at both.



**Taxable refunds of state and local taxes.** Large refunds on previous returns may indicate that the taxpayer overwithholds as a savings strategy and will be entitled to a substantial refund for the current year.

**Retirement plan distributions.** The expert will trace these funds to determine whether they were rolled over into other tax-deferred plans or used for some other purpose.

**Alternative minimum tax (AMT).** AMT entries may indicate shelters, credits or other tax preference items, which *may* be evidence of hidden assets, such as real estate or incentive stock options.

**Refund amount.** Here, the expert will review large refunds from previous years and trace the proceeds. A taxpayer may hide assets by intentionally overpaying taxes in one year (for example, by neglecting to claim a tax benefit to which it's entitled) and then amending the return and claiming a refund in a later year.

### Tax return schedules

Even tax return schedules offer a wealth of information on hidden assets. For example:

**Schedule A – Itemized deductions** covers a taxpayer's real estate and personal property taxes. The expert will check reported amounts to be sure they correspond to the underlying property. If they don't, further investigation may lead to undisclosed assets. Entries regarding state and local income taxes may reveal income (or income-generating assets) in other states.

Payments of certain types of interest also can be deducted on Schedule A. Tracing mortgage interest to specific properties can lead to undisclosed real estate. If a mortgage has been refinanced, the expert will determine whether the taxpayer received any cash and, if so, trace the proceeds. An entry for investment interest paid may signal the existence of a margin account, which may contain undisclosed cash or securities.

Miscellaneous itemized deductions also can provide useful information. A deduction for rental of a safe

### HOW DO YOU KNOW IF A TAX RETURN IS LEGIT?

A tax return's value as an investigative tool depends on the accuracy of the information it contains. Today, off-the-shelf software is routinely used to create professional-looking returns. So how do you know if you're looking at the real thing?

Consider asking the taxpayer to complete and sign IRS Form 4506 ("Request for Copy of Tax Return") to obtain a copy of the filed return directly from the IRS. Alternatively, you can use IRS Form 4506-T to obtain a transcript that shows most of the return's line items.

deposit box, for example, may be the only clue available that such a box exists.

**Schedule B – Interest and ordinary dividends** can reveal the existence of foreign asset protection trusts, information that may not be available elsewhere.

**Schedule C – Profit or loss from business** contains information on depreciation, mortgage interest and other expenses that relate to valuable real estate, business equipment or other assets. It also may reveal the existence of profit-sharing or other retirement plans. Insurance expenses may lead to life insurance policies with significant cash values.

**Schedule D – Capital gains and losses** information helps the expert investigate underlying transactions and trace the proceeds.

**Schedule E – Supplemental income and loss** reports income from rental properties, partnerships, S corporations, estates and trusts. The expert will scrutinize the income and expenses for signs that these entities are being used to conceal assets.

### A powerful tool

Whether assets have been actively concealed or simply overlooked, a party's tax returns and supporting schedules can provide valuable clues on where to look and how to draft targeted discovery requests. ♦

# Lost profits or lost value?

Lost profits and lost business value are common measures of damages in commercial litigation. They're also a common source of confusion. Here are answers to some frequently asked questions on the subject.

## What do they have in common?

Lost profits and lost business value are more alike than they are different. Computing lost profits involves projecting future income streams and converting them to present value using a risk-adjusted discount rate. Damages are generally equal to the difference between the profits a plaintiff would have earned but for the defendant's wrongful conduct and the actual profits the plaintiff earns — and is expected to earn — after the injury date.

Lost business value is commonly used to measure damages when a business is destroyed, and it often involves essentially the same methodology. When income-based valuation methods are used, determining lost business value is like calculating lost profits, except the business loses *all* its profits.

Even if a business survives, computing lost value may be appropriate if it suffers a permanent injury, such as the loss of a particular product line or division. In that case, damages might be measured by the difference between the business's value before and after the injury.

## How are they different?

Despite similar methodologies, in most cases there are significant differences between the two measures. Lost profits are usually measured over a specific time period, such as the remaining term of a breached contract or the time it will take the plaintiff to restore "normal" profits. With lost business value, on the other hand, profits are projected into perpetuity.

Also, a business valuation views the business from the perspective of a hypothetical buyer, while a lost profits analysis views it from the plaintiff's perspective. The differences in perspective can result in very different assessments of risk and, therefore, different damage estimates.



For example, a plaintiff who has developed considerable personal goodwill and industry contacts might view the business as less risky than would an outside buyer. Lost profits may also reflect the plaintiff's specific tax situation or other factors that result in higher or lower earnings than a hypothetical buyer might experience.

Another important difference is that business value generally is based on facts known or reasonably

knowable on the valuation date, regardless of what has actually transpired between that time and the trial date. But it may be appropriate to consider subsequent events in determining the amount of lost profits.

Finally, business value may incorporate discounts for lack of marketability or liquidity.

### Can a plaintiff recover both?

Yes, but only with respect to different time periods. If a business suffers lost profits during the period following the defendant's wrongful conduct but has been permanently injured or destroyed by the time of trial, it may be appropriate to recover lost profits for the initial period and lost business value as of the date the damage becomes permanent.

Keep in mind that an award of both lost profits and lost business value for the same, or overlapping, time periods counts the same income streams twice, resulting in a double recovery. This is true regardless of the valuation approach used. Even if market- or asset-based valuation methods are used, a business's value is still derived from its capacity to generate profits.

### Damage control

A basic understanding of the similarities and differences between lost profits and lost value can help you build a case for business damages or challenge your opponent's calculations. A valuator can be instrumental in deciding the correct approach. ♦

## Marketability discounts

# Appraisers relying less on empirical study averages

With the widespread availability of public market databases, spreadsheet software and other analytical tools, valuers are no longer relying solely on empirical study averages to determine marketability discounts. They're now placing greater emphasis on how to identify what truly affects marketability and how to better match empirical data to the specific attributes of each subject company.

According to the *International Glossary of Business Valuation Terms*, marketability is "the capability and ease of transfer or salability of an asset, business, business ownership interest or security." The quest for valuers, therefore, is to find acceptable methods for quantifying the discount for lack of marketability.

### Going to market

Among other things, marketability encompasses access to and costs associated with public offerings. Large public stocks — say, shares of IBM or

Wal-Mart — are fully marketable. Investors in these securities can typically convert their investments to cash in less than 72 hours. Minority interests in small private companies represent the other end of the spectrum. That is, they lack access to a ready market and, therefore, require more time and effort to sell — assuming they can be sold at all.

When a valuator uses the income or market approach to value a private business interest, his or her preliminary conclusions are cash-equivalent values derived from analysis of public market data. In other words, valuation approaches generally appraise the company on a "marketable" basis. These preliminary values require an adjustment — commonly referred to as the discount for lack of marketability — to reflect a private business interest's lack of marketability.

The question becomes: How should the discount for lack of marketability be quantified?



### Then and now

Decades ago, business valuation was a relatively new and untested profession. Valuers generally took an average from a pre-initial public offering (IPO) or restricted stock study, and then subjectively modified the average based on the subject company's specific characteristics. When a company undergoes an IPO, it must report all stock transactions that have taken place within three years of the offering. Analysts compare these pre-IPO transactions with the companies' subsequent offering prices to support the discount for lack of marketability.

With restricted stock studies, prices that accredited private investors pay for restricted shares are compared to the prices public investors pay for SEC-registered shares. Because the SEC limits transfers of restricted shares, they're less marketable than registered stock, making them a viable proxy for the discount for lack of marketability.

Now, most valuers have abandoned the blanket use of empirical study averages and instead are solidifying their understanding of pre-IPO and restricted studies and analyzing any relevant market data before determining marketability discounts.

### Data still relevant

Although pre-IPO and restricted stock studies may be somewhat under siege, their data is still worthwhile. Research has generated these insightful hypotheses:

**Discounts based on pre-IPO studies or restricted stock underestimate the difficulty of transferring a private company interest.** Some private companies may require an additional adjustment — beyond those supported by empirical studies — to reflect their relative lack of marketability. For instance, pre-IPO studies include more materially different types of companies (in terms of size, management quality and access to financial data) than they do closely held businesses. Similarly, though restricted stocks are subject to a one-year holding period, they're registered with the SEC and, therefore, are more marketable than private business interests.

**Specific factors affect a company's marketability.** Among those factors are firm size, block size, stock volatility and external market conditions. Valuers can use these factors as selection criteria to link pre-IPO or restricted stock transactions to the subject company on the valuation date.

**Public stock returns give insight into private company volatility.** Volatility (or financial risk) is one of the key determinants of marketability. A public company's volatility is simply the standard deviation in stock returns over time. But for thinly traded public stocks or a private company, volatility is in the eye of the beholder.

Experts have analyzed public stocks and identified several proxies of volatility. Some valuers use these proxies to estimate a closely held company's volatility. Among the financial characteristics found to affect volatility are size, balance sheet strength, profitability and dividend payments.

### In the final analysis

Determining valuation discounts is one of the more challenging aspects of valuing a business. And as new ways to measure marketability discounts are revealed, some hypotheses will survive, while others will be proven faulty. That's why it's important to work with an expert in the valuation field. ♦

# Putting a price on technology

**V**aluing technology-related intellectual property (IP) can be an enormous challenge for lawyers and valuation experts. It considers the degree of legal protection associated with technology IP as well as the economic benefits a company is expected to derive from that protection.

Technology IP may include several types of assets, including patents, copyrights and trade secrets. The need to value these assets can arise in a variety of contexts, including litigation, financial reporting, mergers and acquisitions, strategic planning, and tax planning.

## Valuing economic benefit

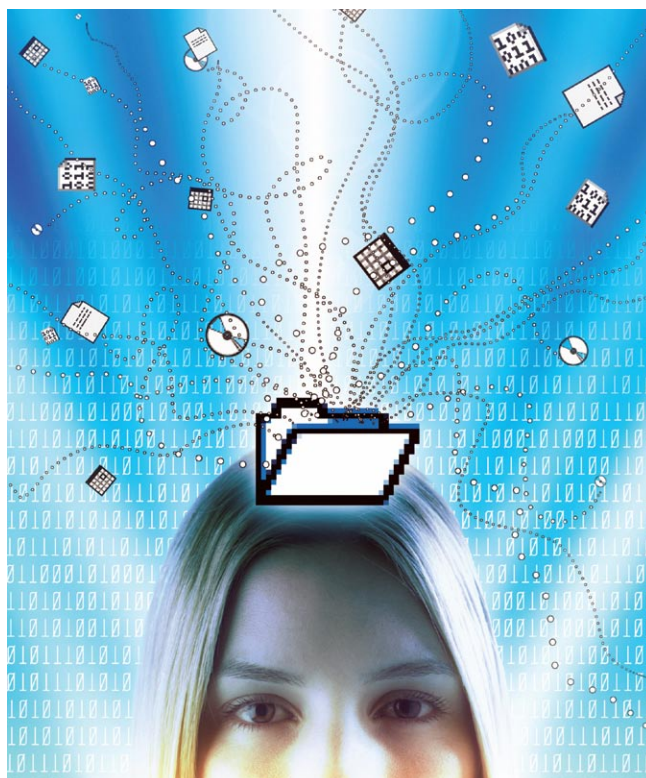
One of the most challenging tasks is identifying the revenues or other economic benefits attributable to technology IP. If the company derives its revenues from licensing, it may be relatively straightforward. But many companies use technology to develop numerous products or streamline processes, which creates multiple sources of revenue and cost-savings.

Typically, valuation experts analyze the various economic benefits associated with a technology IP asset separately. Each benefit presents different risks, which should be reflected in the discount rate used to convert projected income streams into a present value. For example, a patent may be associated with developed technology, in-process research and development (IPR&D), and future technology.

Developed technology, such as a current product, can be traced to relatively predictable revenue streams. The economic benefits of IPR&D are riskier, which generally is reflected in a higher discount rate, while future technology presents the greatest risk. Another risk is whether the legal protections will hold up to challenge. Could a court find a patent to be invalid? Are proper steps in place to protect a trade secret from prying eyes?

Current accounting standards provide detailed rules for valuing and reporting technology IP and other intangible assets acquired in a business combination. For example, developed technology is recorded at fair value, while acquired IPR&D projects are capitalized at fair value and then tested annually for impairment until they're completed or abandoned. The value of future technology is captured as part of goodwill.

Another challenge in valuing technology IP is determining its economic life. This requires consideration of product development cycles, obsolescence, innovation in the industry and the duration of available legal protections.



## Work with experts

Technology-related intellectual property is a significant component of value for many companies today. Lawyers should be prepared to work closely with valuation experts to put a price tag on these assets. ♦