

# Forensic Forum

published by the Barson Group

## Calendar

### Recent and Upcoming Speeches Include:

#### September 2005

**20** - Middlesex County Bar - Forensic Accounting (New Brunswick)

**30** - AAML - Valuation in the Extreme (Atlantic City)

#### November 2005

**15** - CPA Club - Investigative Accounting Process in Litigation (Saddle Brook)

**21** - Judicial College - Tax Aspects of Settlements (Fort Lee)

#### December 2005

**9** - Florida Institute CPAs - Basics of a Financial Investigation (Ft. Lauderdale) (full day course)

#### January 2006

**8** - Men's Club of Temple Sholom - Tax & Financial Planning (Bridgewater)

#### April 2006

**26** - ICLE - Determining Income & Expenses (TBD)

#### Ongoing

#### The BARSON GROUP CLE Series

- September 12, 2005
- November 10, 2005
- November 15, 2005
- November 30, 2005
- February 8, 2006

#### Recent and Upcoming Media Situations:

• **Book - Second edition of Investigative Accounting in Divorce** by Kal Barson, published by John Wiley and Sons

• **Book - Business Valuation: The Basics** - by the Staff of The BARSON GROUP

• **Book - Divorce Valuation: The Basics** - by the Staff of The BARSON GROUP

• **Chapter - Divorce Taxation - NJ Family Law** by Lexislaw (April 2005)

• **Article - Litigation Awards: A Taxing Problem** - New Jersey Lawyer (September 5, 2005)

• **Article - Investigative Accounting - A Force in Matrimonial Practice** - American Journal of Family Law (winter 2006)

• **Article - Role of Financial Expert in Mediation** - Middlesex County Bar Association Advocate (January 2006)

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Volume 5 - Issue 1

Winter 2006

## Income Becomes Outcome

**I**n the valuation of closely held companies, without question the most common approach to valuation involves the use of income - as contrasted with the cost or market approaches. Thus, logically the single most important number in doing an income approach is the income that is used in the calculation.

Since the income figure is all that important, it is crucial to understand how income is chosen. This article will not focus on the forensic accounting that results in adjustments to determine income. Rather, this article starts with the results of the forensic accounting - the restated income, say for five years. This is fairly common and familiar to our readers. The issue becomes how to use those five years of reconstructed income. Do we take just the most recent year, a straight average of the five years, a forward weighted average, a reverse weighted average, do we disregard one or more years and then take an average of some kind? This is an often overlooked and underappreciated aspect of the judgment call and professionalism demanded of the valuation expert. A few simplified examples will illustrate this point very clearly.

Let us assume that the results of the forensic analysis reveal that the subject company has had net income for the past five years (the most recent year stated first) of \$500, \$400, \$300, \$200 and \$100. You can add zeros to your hearts content to make it fit the size business you would like. The straight average of those five years is \$300; the weighed average (putting the most weight on the most recent year and then less weight progressively on each of the older years) is \$367. Consider our choices:

- Straight average - a simple concept, suggesting that each of the years is of equal relevance. If subject to a rigorous challenge, would it hold? Is it reasonable to assume that a business which shows steady increases, for purposes of projecting income going forward upon which a valuation will rely, should use an income level of three years ago?
- By somewhat the same logic, would you use a weighted average of \$367. This brings the number being used closer to the current year's income, and gives proportionally greater weight to the more recent years. The theory is that in general, the most recent

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years are more relevant to the future than the older years.

- Or, would you use only the most recent year, arguing that the older years have set the stage for where this business is going, and that the trend weighs heavily against using income that has already been surpassed and, based on the trend, no longer relevant to the business?

This is obviously a critical issue that must be addressed in an unbiased fashion. Simple arithmetic suggests that, all other things being equal, using \$500 would result in a value 70% greater than using \$300, and 40% greater than as compared to \$367; or using \$367 as compared to \$300 will result in a value difference of over 20%.

Assume for the moment the same set of numbers, but reversed - the company's income is on a downward slope, with the most recent year \$100, and the prior years progressively \$200, \$300, \$400 and \$500. The same stream of logic applies here, only in reverse. The essential question is why consider an average (and there can be some very good reasons) when the subject business's trend suggests that what was likely is no longer relevant?

The preceding was almost too easy. Let us assume the same set of numbers but mixed around - the income stream for five years shows \$300, \$400, \$100, \$500, \$200. It really does not matter whether those five years are from the most recent back or from the oldest forward - there is simply no pattern, no apparent predictability to those numbers. We still have the same type of questions - do we use a straight average, a weighted average in one direction or the other, or some other assumption? Barring something unusual, since a trend is not evident, it would seem logical that an average must be used, and that probably it would be a straight average rather than any kind of a weighted average. A weighted average gives greater weight to certain (generally the most recent) years. In this example there would appear to be no logic in giving any one year more weight than any other year.

Let us make life a little more complex - of our five years, one or two are outliers. Interestingly, if more than two years were outliers, we would have no outliers because there would be nothing against which to benchmark. Let us assume that the five years at hand, starting with the most recent and going back, are \$200, \$300, -\$500, \$400 and \$100. The essential issue to be addressed is do we disregard the one clear outlier year (the middle year with a negative) or not? The argument in favor of dropping that year is that it is clearly an outlier - not only is it the one year with a loss, but it is several hundred away from any of the other years. Thus, it would be appropriate to disregard that outlier year, and use the remaining four to determine whether you were going to do an average or whatever. On the other hand, one might argue (presuming and hoping that one has a foundation for this argument) that this business is cyclical, that every few years a loss is to be expected, and thus that one outlier year cannot be ignored. This illustration takes advantage of presenting a clearly outlier year - it would hardly be unusual to have a tighter range of income and losses, and therefore a judgment call that is not so obvious as to whether or not a year is an outlier.

It is one step further to consider that there are two large loss years instead of one. Would we now have two outliers to disregard - or would the presence of two large losses suggest no outliers, but likely an expected greater variation in the income stream from year to year. Further, would that conclusion vary if the large loss year (or years) was the most recent or the second most recent as contrasted with an older year. This exercise becomes all the more difficult when the so-called outlier is the most recent year. One line of argument might suggest that it is not an outlier, but rather a new standard going forward. There are no simple answers to these issues - but they warrant discussion and analytical support for whatever conclusion is reached.

Thus, beyond the obvious that the choice of income for determining the value of a business is important, we can have the far more complex issue of how to pick the appropriate (and there can be more than one appropriate - depending on interpretation) income stream when there might be no single clear cut answer. Whatever figure is used, whatever kind of average is chosen, whatever judgment calls are made - it is appropriate to expect, to demand, that there be an explanation and logic for any such subjective conclusion.

There is at least one further complicating tangent to consider. When using income to make a determination of value, we do so by applying a capitalization rate (or multiple) to the determined income stream. That cap rate is a reflection of risk - risk as to the likelihood that income stream will continue. A high cap rate (a low multiple) is a reflection of relatively greater risk as to that income stream continuing. Conversely, a low capitalization rate (a high multiple) is an indication that the appraiser has determined there is relatively lesser risk as to that income stream continuing.

Thus, it would be possible to use two different income streams and two different capitalization rates - for the same business, for the same grouping of incomes and for the same valuation. To illustrate, consider the first example in this article - the most recent five years of income, starting with the most recent year and going back, were \$500, \$400, \$300, \$200 and \$100. Assume the appraiser has determined that the appropriate income going forward is most likely either a weighed average (\$367) or the most recent year (\$500). However, the appraiser is not comfortable that either one of these is more reliable than the other - while the trend shows \$500, there is concern that the trend may not continue, it may level off, it may settle down a bit. On the other hand, a weighted average of \$367 might be giving too much credit to the past and not enough respect to what is likely the

future. We might address these concerns by the use of two different capitalization rates.

Assume it is reasonable that a weighted average of \$367 is less risky than the use of a \$500 trend. Or, from the other angle, the use of \$500, while considered sound business valuation theory, carries with it greater risk (it is the highest year and relies on the trend continuing) than the use of a weighted average of \$367 which is not so reliant on the trend continuing. Therefore, the approach to value might be to use, by way of example, either a 16% cap rate (a multiple of 6 1/4) on the weighted average \$367 - resulting in a value of \$2,294; or a cap rate of 20% (a multiple of 5) on the trending \$500 - resulting in a value of \$2,500. Since these figures are close, the valuation expert would typically average them, resulting in a conclusion of value of \$2,397. These involve subjective interpretations - what you call upon the valuation expert to exercise. An alternative would be to indicate that, rather than a single number conclusion, the range of value is between \$2,294 and \$2,500. That would not be unreasonable.

The critical issue is the appropriate income to be employed in the determination of value. There is a significant amount of expertise and judgment call required to conclude appropriately.

## **FOCUS ON FUN**

### ***Accountants & Humor – A Sociological Fable***

1. A student from Indianapolis supplemented his income by buying goldfish wholesale, and then selling them, in individual bowls, retail. We now get into the area where a little knowledge is dangerous (and also smelly). He knew that the cost of fish that had died could be written off as a legitimate business loss. However, he had a question for the IRS - whether he should continue to keep the dead fish in his freezer to prove his deductions.
2. Some people kind of "get even" with the IRS by sending them things that are either somewhat out of the ordinary or not quite what would be expected. One taxpayer sent a blown up copy of a form 1040 printed on a shirt, indicating to the IRS that they had taken the shirt off of his back. Another, with somewhat of the same attitude, but harsher, sent the IRS a replicated 1040 on a six foot long piece of butcher's paper. One woman sent along a lock of her hair, explaining that she felt scalped after filling out the return. Another woman sent a pair of well soiled panties - apparently leaving it to the imagination of the IRS what the actual deeper meaning was. A man included a handful of buttons, with a letter explaining "here are the buttons, you got the shirt last year". Another man sent a comb, explaining that he did not need it anymore because he had pulled out all of his hair trying to figure out his income taxes.

# ***The Innocent Spouse and Other Fables***

In recent years, there has been significant improvement (from a taxpayer's perspective) of the rules on what is needed in order to qualify as an innocent spouse. It is a safe statement that the changes brought about in this area were uniformly favorable to taxpayers, greatly easing what was necessary to qualify as an innocent spouse, without the IRS taking back with one hand what it gave with another. This article will very briefly provide an overview of the innocent spouse area as it relates to taxation - it is of particular interest in the area of divorce litigation.

It is important to keep in mind that the need for innocent spouse protection arises out of a tax, penalty or interest assessment against a joint tax return, where one of the spouses has (possibly) a basis for claiming innocent status. The key issue here is the filing of a joint return. You cannot claim innocent spouse on a separate return - because it is your own. The filing of a joint return binds both people to that joint return, creating joint and several liability - thus creating the possibility for the need for protection as an innocent spouse. A joint tax return is optional - it is available only to married couples, but is not a required form of filing. Either spouse has the right to not file jointly - to file married separately. Of course, there may be a wide range of other issues that have to be taken into account, especially when a divorce action is being conducted and one spouse refuses to sign a joint return, creating additional tax liabilities. It is certainly possible, in the absence of a solid reason not to file a joint return, that the spouse refusing to do so may be charged with the responsibility for the additional tax burden. That's a separate issue, and not directly related to the innocent spouse concerns.

The basic rule, with a very significant area of grace (which will be referenced afterwards), is that to qualify as an innocent spouse, one need not to have benefited from the wrongdoings of the other spouse, and need not have known of the wrongdoings. Most of us will read these words and believe that perhaps relatively few spouses can indeed qualify, since even the most ignorant spouse tends to have some knowledge of what's going on, and just living together tended to benefit from the income. However, the IRS was basically instructed, and tends, to treat this area gently with a liberal approach towards the taxpayer. Largely, this can be attributed to Congress' concerns (which for the most part were well founded) that all too many women, many of them going through a divorce or abandoned, were suffering greatly under a system that treated the wrongdoer, as well as the often long-term spouse who went along because there was little else possible, as equally culpable. Thus, even if there is doubt as to a person's real "innocence", you may be surprised as to who can actually qualify.

Earlier in this article there was reference to an area of grace - this revolves around the word inequitable. That is, if all else fails, if your client probably doesn't make it as having been ignorant of what was going on or in another

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way qualify as described above, the safety catch-all is that it would be inequitable to hold that spouse responsible for the tax burden. This cuts across a wide swath of possibilities, and is often the difference between a person qualifying and not qualifying as an innocent spouse. Thus, even a spouse who knew that there was something wrong, but perhaps was effectively powerless to do anything about it, will get the IRS' blessing of innocence. Note that there is a difference between what would truly qualify someone as "innocent", or what would be qualified as "inequitable" in a court of law (certainly all of the readers of this article are well versed in that area and know how they can pick apart claims of such innocence or inequity) - as contrasted to what the tax law is intended to do in this area, and what the IRS is willing to consider either innocence or inequity.

Examples of some of the situations which might cause the need to seek innocent spouse protection include:

- A tax balance is due with the return and has never been paid
- One spouse with a business with unreported income
- Very substantial (egregious) perquisites taken from the business of one spouse
- Withdrawing money from a retirement plan and not paying taxes on it
- Omitting a K-1 from the return
- In general, any action or inaction that results in a tax, penalty or interest due to the IRS

Timing may be a critical issue. The caution here is that there is rarely a reason to rush into a claim of innocent spouse. Seeking to secure innocent spouse status too soon (i.e. before an actual IRS attack), may simply alert the IRS to a problem area, bringing it down on everyone for no good reason. In addition, if the IRS does not see things your way, if they do not consider your client an innocent spouse, you have now created an IRS conflict where perhaps none would be. The key point is that there is no reason to file for innocent spouse protection until you are aware that something needs protecting. The rules provide that you can seek innocent spouse protection within two years from when the IRS starts an action. For this purpose, an action would include notice of a tax examination, collection notice or something along those lines. Thus, why precipitate IRS attention before it is necessary?

Request for innocent spouse determination is done through the filing of a Form 8857. Like so many other tax filings of major consequence and complexity, this is one that should not be done by the client, but rather, whether through your direction or otherwise, by a tax savvy CPA. Usually, the forensic accountant involved in your matter, providing that he/she has not been engaged as a neutral or court appointed expert, would be the most likely one to proceed in this direction.

**Divorce Taxation: The Basics** - our new book, 40 pages explaining Divorce Taxation in layman's terms, is available - complimentary copies for the asking. Contact us if you haven't received your copy.

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