Munroe, Park & Johnson, Inc.

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Increase in IRS Audits of Partnerships?

According to Faris Fink, Commissioner of the IRS Small Business/Self-Employed Division, the Internal Revenue Service (IRS) is shifting its small-business audit focus from corporations to partnerships. The goal is to increase audits of partnership tax returns with an emphasis on administrative matters. Over the past year, the IRS has provided advanced partnership examination training to their revenue agents.

According to IRS statistics, pass-through companies comprise nearly 95% of all U.S. business entities. In just four years, 2007-2011, the number of partnerships grew by 15.3% and now amount to a significant percentage of returns for both the IRS Small Business Division and Large Business and International Division.

With the IRS increasing audits on partnerships, it is important to review the *IRS Partnership Audit Technique Guide*. (This guide is the manual used by IRS auditors when auditing partnerships.) Two key issues the IRS is concerned with are:

1. **Income shifting using family partnerships.** IRC section 704(e)(2) provides that a donee's share of partnership income must be reduced to the extent of the donor's reasonable compensation for services rendered to the partnership. To be considered a partner for the purpose of receiving income allocations, the partner must be an owner in substance and not just form.

2. **Family partnerships and transfer taxes.** Estate and gift taxes are imposed on the transfer of property at death or the gifting during lifetime by a decedent or donor, respectively. Filing a gift tax return starts the 3-year statute of limitations regardless of whether the taxable gifts were fully sheltered by the unified credit.

Chapter 11 of the *IRS Partnership Audit Technique Guide* provides agents with examination techniques for auditing family partnerships. The chapter starts out with an introduction stating that the original emphasis of family partnerships was to divide income among family members. It states that the focus has now shifted to take advantage of partnerships to reduce estate and gift taxes.

The *IRS Partnership Audit Technique Guide* recommends that any case where substantial discounts are claimed be referred to the Estate and Gift Tax group. Some of the techniques used to identify family partnerships for review include:

- Does the partnership name include the word "Family"?
- How long as the partnership been in existence?
- Does the Schedule K-1 indicate family relationships between the partners?
- Are there disproportionate allocations of income between family members?

Regardless of the increased attention, partnerships with valid business purposes can and will still be used by taxpayers for their intended purpose.

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Lack of Business Appraisal – No Deduction

In the tax case of Estate of Harvey Evenchik, Gregory V. Gadarian, personal representative, and Deanna C. Evenchik, petitioners v. Commissioner of Internal Revenue, Respondent, the petitioner lost a significant tax deduction because they failed to have a proper business appraisal conducted.

Background

In 2005, the petitioner donated 15,534.67 shares of common stock in Chateau Apartments, Inc. to a charity to create an endowment fund to assist low-to-moderate–income individuals in obtaining affordable housing. The company's primary assets were two apartment complexes located in Arizona. The petitioner's donation equaled 72% of the company's stock and the value was claimed to be $1,045,289.

The Deductions

As supporting back up documentation, the petitioner submitted two real estate appraisals of the underlying assets in the corporation, but neither appraisal addressed the individual shares or the petitioner's 72% interest in those shares. This should have been done with a business appraisal. In addition, the appraisals did not include a statement that the appraisals were prepared for income tax purposes.

The petitioner claimed the deductions across two tax years. In the second tax year, the return was audited and the entire deduction (across both years) was disallowed and a notice of deficiency was issued. Most of the issues at hand were settled except one question. Did the petitioner obtain a qualified appraisal on the donation, which in this case amounted to shares in a company?

The Regulations

IRS regulations govern the deductibility of charitable donations. Section 170 of the Internal Revenue Code requires a taxpayer claiming a deduction for the donation of property worth more than $5,000 to "obtain a qualified appraisal for the property contributed." Section 170(f)(11)(E)(ii) provides that the term "qualified appraiser" means an individual who:

(1) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Secretary,

(2) regularly performs appraisals for which the individual receives compensation, and

(3) meets such other requirements as may be prescribed by the Secretary in regulations or other guidance.

Section 170(f)(11)(E)(iii) further provides that an individual will not be treated as a qualified appraiser unless that individual (1) demonstrates verifiable education and experience in valuing the type of property subject to the appraisal, and (2) has not been prohibited from practicing before the Internal Revenue Service by the Secretary under § 330(c) of Title 31 of the United States Code at any time during the 3-year period ending on the date of the appraisal.

Income tax regulations say that no deduction under section 170 shall be allowed with respect to a charitable contribution unless the donor obtains a qualified appraisal for the property contributed. If the contributed property is a partial interest, the appraisal shall be of the partial interest.

A Cascade of Deficiencies

The first problem for the Estate of Harvey Evenchik was that the appraisals presented were not appraisals of the interest donated. They were appraisals of the underlying assets held by the company. The court recognized that the status of a partial interest may have an effect on total value that should be assessed.

In addition, income tax regulations require a qualifying appraisal to contain all of the following, most which the petitioner did not provide:

- A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was (or will be) contributed;
- In the case of tangible property, the physical condition of the property;
- The date (or expected date) of contribution to the donee;
- The terms of any agreement or understanding entered into by or on behalf of the donor or donee that relates to the use, sale, or other disposition of the property contributed;
- The name, address, and the identifying number of the qualified appraiser;
- The qualifications of the qualified appraiser who signs the appraisal, including the appraiser's background, experience, education, and membership, if any, in professional appraisal associations;
- A statement that the appraisal was prepared for income tax purposes;
- The date (or dates) on which the property was appraised;
- The appraised fair market value of the property on the date (or expected date) of contribution;
- The method of valuation used to determine the fair market value, such as the income, market or asset based approach; and
- The specific basis for the valuation, such as specific comparable sales transactions or statistical sampling, including a justification for using sampling and an explanation of the sampling procedure employed.

Conclusion

The Tax Court concluded that the proper appraisal was not conducted and the real estate appraisals of the underlying assets were not a qualified appraisal for purposes of valuing a charitable income tax deduction for a contribution of the corporation's stock. The Estate of Harvey Evenchik was denied all deductions taken from the donation.

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Five Common Errors in Goodwill Impairment Testing

Under Accounting Standards Codification ("ASC") 350, *Goodwill and Other Intangible Assets,* a company is divided into one or more reporting units, and a separate goodwill impairment test is performed annually at the reporting-unit level.

The first step of the goodwill impairment test is to determine the fair value of a reporting unit's total equity, or invested capital and compare that with the carrying value ("ASC 350 Step 1"). If the carrying value exceeds the fair value, then there is an indication of potential goodwill impairment. The total amount of impairment is measured in the second step ("Step 2").

Companies commonly utilize the discounted cash flow ("DCF") method in their goodwill impairment analyses. The DCF method is designed to determine the value of a company's invested capital. (Then, interest-bearing debt is subtracted to determine the fair value of stockholders' equity.)

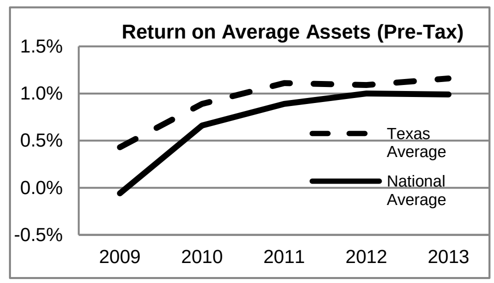
Frequently there may be several problems associated with a company's implementation and key assumptions, such as:

1. **Deprecation significantly exceeds capital expenditures in the terminal year.** In the terminal year (when the reporting unit has reached a stabilized level of cash flow), it is generally the case that a reporting unit is replenishing only those fixed assets that are depleting. Thus, deprecation should be projected to be similar to capital expenditures in the terminal year.
2. **Asset (taxable) vs. Stock (non-taxable) transaction.** For ASC 350-20-35 consideration, the company should select the most likely type of transaction (i.e., asset [taxable] vs. stock [nontaxable]). Under a taxable transaction, the fair value of the intangibles is amortized over a 15-year period for tax purposes. Under a nontaxable transaction, the fair value of the intangibles is carried over for tax purposes.
3. **Amortization expense in terminal value calculation.** Intangible assets are amortized over a 15-year period for tax purposes, therefore, it is not appropriate to assume amortization expense into perpetuity.
4. **Including interest expense in the projections**. When determining the reporting unit's invested capital, interest expense should be excluded from the projections.
5. **No conclusion.** After determining the reporting unit's fair value, the fair value should be compared to the reporting unit's carrying value to determine if Step 2 is required.

Texas Banks 2013 Year in Review

In 2013, Texas banks continued to be more profitable than other national banks. Two common measures of profitability are return on average assets (ROAA) and return on average equity (ROAE). In recent years, the average Texas bank ROAA generally has been higher than the national average. The following chart compares the average Texas banks' pre-tax ROAA to national averages for the past five years.

A company's ROAE depends on its ROAA and the amount of leverage in its capital structure. (Higher leverage magnifies a company's ROAE.) In recent years, the average Texas bank's ROAE has been slightly higher than the national average.

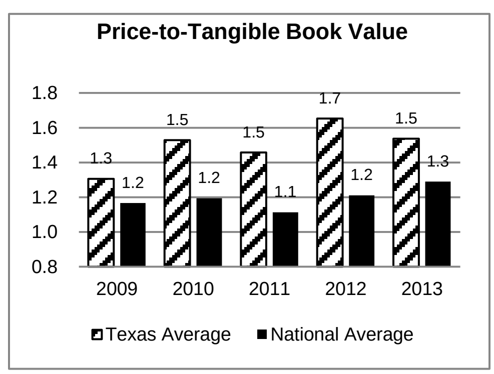


Return on Average Equity

	As of the year ended December 31,				
	2009	**2010**	**2011**	**2012**	**2013**
Texas Avg	4.2%	8.0%	9.4%	9.7%	9.6%
Nat'l Avg	-0.5%	5.8%	7.7%	8.7%	7.9%

A valuation multiple is a ratio in which the numerator is a measure of a company's market value, and the denominator is a balance from a company's financial statements. Two valuation multiples are commonly used in appraisals of banks and bank holding companies:

P/TBV ratio. The numerator of this ratio is the market price of a company's common stock. The denominator is the book value of the company's tangible stockholders' equity. This ratio is commonly referred to as the "price-to-tangible book ratio." Historically, the average Texas bank P/TBV ratio has been higher than the national average. The following chart compares the Texas average P/TBV to the national averages for the past five years.



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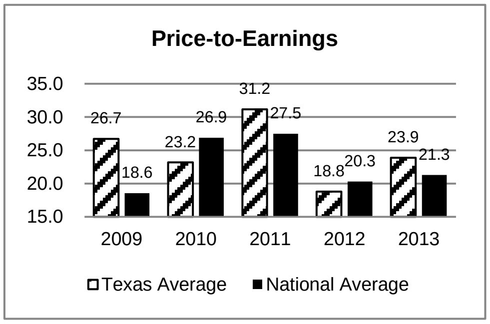
P/E ratio. The numerator of this ratio is the market price of a company's common stock. The denominator is the company's net income for the most recent year. This ratio is commonly referred to as the "price-to-earnings ratio." In 2013, the average Texas bank P/E ratio was higher than the national average. The following chart compares the Texas average P/E to the national averages for the past five years.



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The firm focuses on providing consulting in the areas of business valuation and acquisitions.

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