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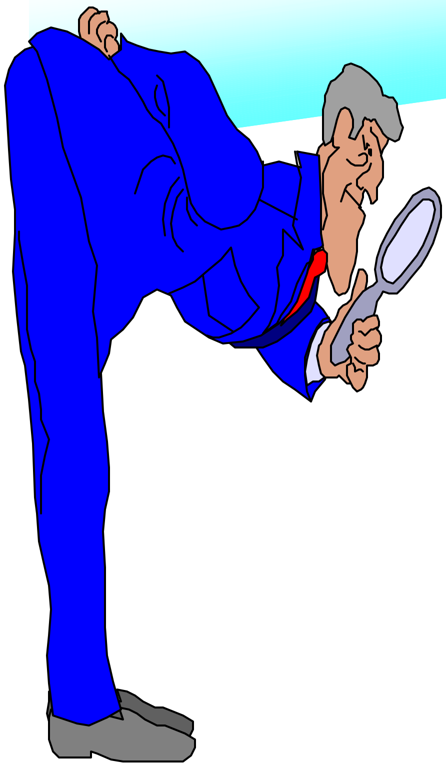

VALUING A BUSINESS IN DIVORCE PROCEEDINGS

by

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1. GENERAL

Valuation issues often are a focal point in settlement negotiations between spouses, or are often the subject of litigation in the family law courts. In many cases, a thorough assessment of an individual's net worth and income-earning capacity is a critical requirement.

2. THE VALUATION BATTLEFIELD: TYPICAL AREAS OF DISPUTE

Differences typically arise with respect to the basic and fundamental requirements for valuing a closely-held, private business enterprise *as a whole*. Judgement must be applied by the valuator with respect to:

- Appropriate valuation methodology to be applied;
- Level of earnings or cash flows to be used;
- Adjustments necessary to normalize reported earnings (accounting profits) in respect of:
    - Non-recurring income and expense;
    - Discretionary expenses;

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  - Non-arm's length expenses;
  - Changes in the business.

- Reasonableness of assumptions underlying management's projections and forecasts;
- Income tax discounts on "trapped-in" capital gains;
- The price/earnings multiple (capitalization factor) to be applied to normalized earnings in order to arrive at the worth of the business; etc.
- Whether a "key person" discount is appropriate (for the loss of services of a key executive).

In addition to the foregoing, often-contentious, areas encountered in the valuation of the business as a whole, non-controlling minority shares must be valued, giving consideration to:

- Minority discounts (for lack of control); and
- Marketability discounts (for the illiquidity nature of the shares).

2.1 Key-Person Discount

In valuing a business, a factor often overlooked is that the loss of a key executive[1] can have a negative effect on the business and on the value of its issued shares, particularly if there is a lack of trained personnel capable of taking over the management of the enterprise. The effect of the loss of the manager on the future expectancy of the business, and the absence of management succession potentialities, are accordingly pertinent factors. The extent of organizational damage may also be related to the suddenness of the key manager's departure.

On the other hand, the nature of the business and of its assets may be such that they will not be impaired by the loss of the key person's services. In certain cases, the loss may be adequately covered by life insurance, or competent management might be employed on the basis of the consideration paid for the key person's services. These, or other offsetting factors, if found to exist, are carefully weighed against the loss of such services in valuing the company's shares.

The valuation discount to reflect the loss of a key individual depends on several factors, one of the most important being the extent of the key person's actual duties, responsibilities and contributions to the business. The key person's primary contribution is often in the form of long-standing customer and/or supplier relationships and general industry know-how. Other important factors impacting the valuation discount include the ability of the other executives and employees of the company to assume the duties of the "vacant" position, the compensation necessary to replace such individual, the reaction of customers, competitors and — depending on the nature of the business — suppliers, upon learning of the loss, as well as the amount of any insurance proceeds on the life of the key person (if death is the reason for the loss).

First, in quantifying the discount, the key person's actual duties and areas of involvement are identified. A key person may contribute value to a company in both day-to-day management duties and from strategic judgement responsibilities based on long-standing contacts and reputation within an industry.

Second, the ability of existing successor management to move up the organizational ladder and take over the duties of the vacated position is assessed. Ideally, a strong and stable corporate organization would provide this capability, assuming a succession plan existed. All too often, however, private business owners create "spider web" organizational structure with themselves at the centre — that is, all management decisions are made by the key executive-owner.

Third, the amount of compensation necessary for replacing the key executive, or filling the positions vacated or created when successors move up, is calculated.

The discount for the loss of the key individual may be incorporated into the valuation conclusion by a number of methods, the effects of which are to discount the going-concern value, or the share value, otherwise arrived at.

This is accomplished by either (a) adjusting the firm's normalized earnings or the capitalization rate to be applied thereto; (b) reducing the projected, annual future cash flows or earnings to be discounted (in a "discounted cash flow" or "discounted future earnings" analysis); or (c) subtracting the key-person loss, as a separate item, from the company's indicated value otherwise determined.

It is interesting to note that Revenue Canada makes no reference to the key-person discount in its *Information Circular 89-3*; however, the United States Internal Revenue Service comments as follows in *Revenue Ruling 59-60*:

> 4.02(b) … The loss of the manager of a so-called "one-man" business may have a depressing effect upon the value of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise. In valuing the stock of this type of business, therefore, the effect of the loss of the manager on the future expectancy of the business, and the absence of management-succession potentialities are pertinent factors to be taken into consideration. On the other hand, there may be factors which offset, in whole or in part, the loss of the manager's services. For instance, the nature of the business and of its assets may be such that they will not be impaired by the loss of the manager. Furthermore, the loss may be adequately covered by life insurance or competent management might be employed on the basis of the consideration paid for the former manager's services. These, or other offsetting factors, if found to

> exist, should be carefully weighted against the loss of the manager's services in valuing the stock of the enterprise.

Both the Canadian and U.S. tax courts have recognized key-person discounts.

2.2 Control and Minority Interests

In quantifying the difference between minority and control values of an enterprise, a broad range of factors exist which influence the impact of control on value. These factors are relevant in a valuation context, as the ability of a controlling shareholder to institute policies which will enhance the value of his/her control position may affect the difference in value between control and minority ownership positions.

For example, certain "degree of control" factors may or may not exist in any specific ownership interest. Among such factors which typically influence the value of a control position in a company involve the shareholder's ability to:

- acquire or liquidate assets;
- appoint management and directors;
- block corporate actions;
- change the articles of incorporation or by-laws;
- declare and pay dividends;
- determine management compensation and perquisites;
- dissolve, liquidate, sell or recapitalize the company;
- make acquisitions;
- register the company's stock for a public offering;
- select people with whom to do business and award contracts;
- sell or acquire treasury shares; and
- set policy and change the course of business.

While business valuators may often encounter numerous obstacles in determining the worth of an entire business enterprise, they often face even greater challenges in valuing a shareholding of

50% or less, as such an exercise requires an even higher degree of subjectivity, judgment and due diligence on the part of the valuator.

2.2.1 Valuation of Total Enterprise

The types of questions that valuators must generally address in appraising the enterprise as a whole (rather than a partial interest therein) include, as appropriate:

- What is the proper valuation methodology in the circumstances: Asset-based, Income-based or Market-based?
- Having selected the valuation methodology, should a going-concern approach or liquidation approach be adopted?
- Considering that valuation is forward-looking, what is an appropriate, representative level of prospective earnings or cash flow to be considered for the entity being appraised?
- What is the appropriate capitalization rate (price/earnings multiple) to be applied to such earnings and what is the basis for the selection thereof?
- Does the enterprise own redundant (excess and/or non-operating) assets which could be removed from the company without adversely affecting its operating ability? If so, how should they be quantified in the valuation?
- Have off-balance-sheet assets, such as valuable intangibles, claims, dies and moulds, been considered and evaluated?
- Are there potential off-balance-sheet claims, such as lawsuits, environmental-liability considerations, which require quantification?
- Does the capital structure permit the introduction of leverage such that a notional purchaser could cause the company to borrow against the company's assets and pay the purchaser a dividend?
- Are there "special purchasers" in the marketplace who might be prepared to pay a premium over and above the stand-alone value of the business because of perceived synergies?
- Have there been non-arm's length transactions of the company's assets or shares proximate to the effective valuation date? If so, are they representative of value in the open market?

- Have underlying income tax considerations been properly evaluated (e.g., with respect to assets versus shares)? Are there "trapped-in" capital gains? Has recaptured depreciation been factored into the valuation?
- If the business being valued is a professional practice, is there an appropriate analysis of the client list by segment (e.g., a law firm's gross billings would be analyzed, giving consideration to the different types of services, such as litigation, corporate and commercial, family law, real estate, taxation, insolvency, environmental, etc.)?
- In valuing an investment holding company which has a large and diverse portfolio of investments, or has various real estate holdings, should a "portfolio discount" and/or a "blockage discount" apply? If so, what size discount?
- If the business being valued is heavily dependent on the skills and efforts of one individual, should a key-person discount be applied to recognize the potential loss to the business if he or she were no longer to able to perform services by reason of death, incapacitation or withdrawal? The Tax Court of Canada approved a 35% key-person discount in arriving at the business' prospective income stream to be capitalized in valuing the company. (*A&N Robitaille* v. *MNR*, 95 DTC 68.)

Many of the foregoing questions, which are far from exhaustive, are typical in valuing the business enterprise as a whole.

2.2.2 Valuation of Minority Interests

However, there are myriad challenging, complex and sophisticated issues when valuing a *specific shareholding* or *specific business ownership interest* in that same enterprise, particularly if it represents less than *de jure* or *de facto* control. Because minority shareholders are often at a disadvantage compared to controlling shareholders, their shares suffer a discount when the degree of control and/or marketability of the interest being valued differ(s) from that inherent in the value otherwise indicated. Such a discount generally applies with respect to the *levels of value*, i.e., the gradations in value at the ownership level which result from differences in ownership attributes. Examples of "levels of value" include:

- Marketable minority-interest value.
- Absolute control value.
- Operational but less than absolute control value.

The value that would be otherwise arrived at is adjusted by an appropriate discount or premium, as described below.

While a control position commands a premium, there may be instances where a minority shareholding would fetch more than its pro-rata, let alone discounted, value. Consider a 2% minority position where each of the other (unrelated) shareholders owns 49%. If there is competitive bidding, the 2% shareholder is in the enviable position of being able to deliver *de jure* control to either of the other two shareholders (who, in this scenario, would be "special purchasers").

Similarly, if the minority shareholding has special "swing vote" characteristics because of the remaining shareholdings, there may be enhanced value offsetting any minority discount (see below). The holder of the minority shares can join hands with one or more other minority shareholders and thus gain control of the board of directors, pass a special resolution to force a liquidation or merger, or to block one.

There are three basic approaches in determining the fair market value of a minority shareholding:

- Value the entire enterprise (which assumes absolute control) and deduct from the pro-rata value of the minority shareholding any discount(s) for lack of control and/or lack of marketability (a so-called "top-down" approach);
- Value the shareholding by direct comparison with other minority shareholdings that may be truly "comparable"; and
- Value the shareholding using a "bottom-up" approach based upon the present value of the future returns that the minority shareholder may anticipate from his or her shareholding.

Canadian business valuators generally adopt a "top-down" approach.

The two principal discounts typically deducted from the pro-rata value of private-company minority shares are the *minority discount* (relating to lack of control) and the *marketability discount* (relating to lack of liquidity).

2.2.3 Minority Discount

In quantifying the minority discount, factors considered include the size of the minority interest, the shareholder's relationship to the other shareholders, the dispersion of the other shares, whether group control exists, the degree of harmony among the shareholders, whether there are identifiable special purchasers, dividend history and policy, the degree of influence on management policy, the terms of the buy-sell agreement (if any), etc. Over the years, Canadian tax courts have addressed the size of the discount, which often ranges from 10% to 20% and higher. Concerning family members' minority shares in a family-controlled corporation, Revenue Canada's position is that there is generally no discount. In the United States, however, IRS *Revenue Ruling 93-12* does permit a minority discount on family members' minority shares. This policy is the direct result of the IRS having lost several cases on this issue in the U.S. Tax Court.

In non-tax cases, such as matters dealing with shareholder appraisal rights, a minority discount is not applicable in determining the "fair value" of a dissentient's, or oppressed shareholder's, shares under the company law statutes.

2.2.4 Marketability Discount

The *marketability discount* is separate and distinct from the *minority discount* and is applied to a different valuation base (see example). The distinction between these may be outlined as follows:

A *minority discount* reflects a decrease in value due to lack of control (as noted above), and such decrease (discount) is subtracted from the rateable (proportionate) share of the *en bloc* value of the total common equity, or partner's equity, including control. As a *marketability discount* reflects the decrease in value due to the illiquid nature of the investment, the objective value-base with respect to which the decrease (discount) is referenced is a security having the same investment attributes except that it can more readily be liquidated.

> The concept of *minority interest* deals with the relationship between the interest being valued and the total enterprise … . The primary factor bearing on the value of the minority interest in relation to the value of the total entity is the degree of control the minority interest does or does not have over the particular entity. The concept of *marketability* deals with the liquidity of the interest, that is, how quickly and certainly it can be converted to cash at the owner's discretion.[2]

Since a minority interest discount reflects a value decrement due to lack of control, the value base from which the minority interest discount is subtracted is its proportionate share of the value of the total entity (or at least the common equity) taken as a whole, including all rights of control. Since a discount for lack of marketability reflects a value decrement due to lack of liquidity, the value base from which the discount is subtracted is the value of an entity or interest that is otherwise comparable but enjoys higher liquidity (that is, can more readily be sold and converted to cash).[3]

For example, if a minority interest in a privately-held corporation, or partnership, is valued by reference to trading prices of publicly-held shares, or real estate investment trust units (as the case may be), privately-held non-marketable minority interests are being compared with liquid, publicly-traded minority interests. The private-company shares or partnership interests (as the may be) are accordingly discounted for the lack of marketability *vis-à-vis* the publicly-traded securities, but not in respect of the minority-interest aspect, as the publicly-traded security is also a minority interest and, accordingly, already reflects a minority discount.

In *Business Valuation Review*, the official publication of the Business Valuation Committee of the American Society of Appraisers, Washington, D.C., an article on the subject makes the following observation:

> "A minority interest in a privately-held firm should contain an even greater discount for lack of marketability than a control share. We see from these studies in Pratt that there is a pure discount for lack of marketability even when there is no question as to the ability to convert to cash on a specified date (again the amount is uncertain, but the ability to convert to cash hence time at which it can occur are both certain). When we compare a minority letter stockholder to a private company minority stockholder, the latter is obviously much less marketable. It may take 30 years to sell the private stock, and it may never sell. The majority owner can even cash out, selling his shares only without the firm as a whole, leaving the minority shareholder still sucking wind, waiting for a knight in shining armor. In the meantime, private firms rarely ever pay dividends, while letter stockholders may well be receiving them."[4]

Moroney, in an article published in the March 1973 issue of *Taxes* (a U.S. periodical), noted:

> "Obviously the courts in the past have overvalued minority interests in closely-held companies for federal tax purposes. But most (probably all) of those decisions were handed down without benefit of the facts of life recently made available for all to see."
>
> "Some appraisers have for years, had a strong gut feeling that they should use far greater discounts for non-marketability than the courts had allowed. From now on those appraisers need not stop at 35 percent merely because it's perhaps the largest discount clearly approved in a court decision. Appraisers can now sight a number of known arm's length transactions in which the discount ranged up to 90 percent."[5]

Having discounted the minority shares for lack of control, the result is the "marketable minority-interest value" ("MMIV") or the "as-if-freely-traded" minority share value. A marketability discount, which recognizes that private-company shares cannot be readily sold (e.g., by simply phoning a stockbroker), is then deducted from the MMIV. While there are little empirical data relating to the size of such discount for Canadian private-company shares, there are a host of

U.S. data which can be gleaned from studies performed during the past twenty-odd years; they support a deduction of 35% to 45% from the MMIV.

Quantifying the marketability discount includes consideration of factors such as current and future dividends; prospects for gaining liquidity, e.g., a sale, refinancing or going-public or having put rights, etc.; and holding-period risk, such as the volatility of earnings and cash flows.

The following "reconciliation" schedule highlights the discounting of a minority position in a closely-held company from rateable (pro-rata) value to its fair market value in the marketplace:

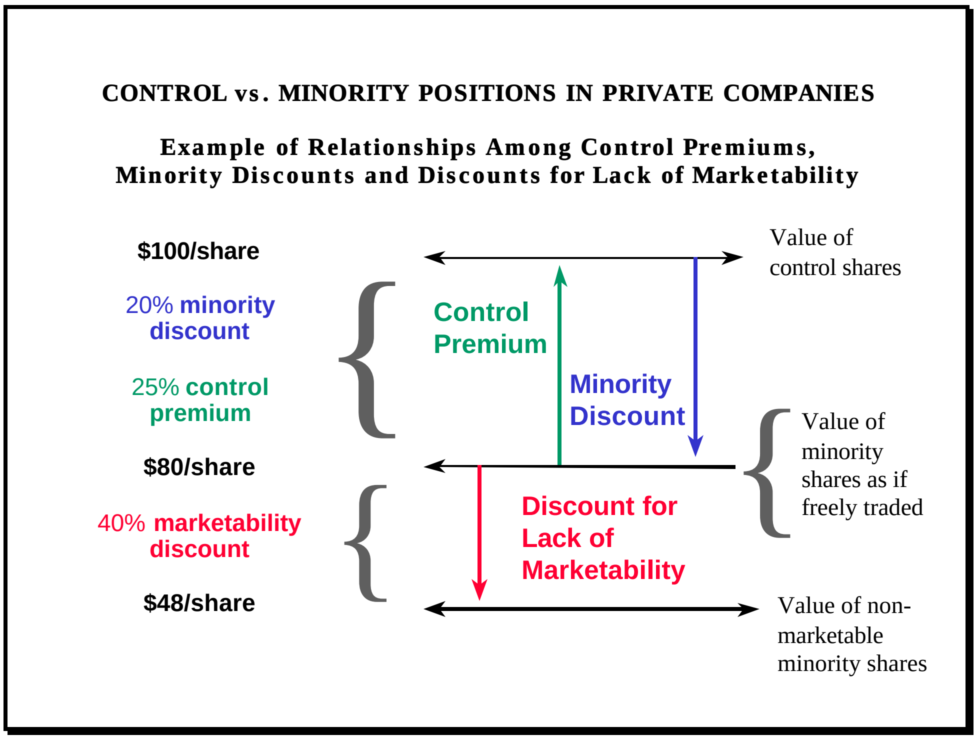
Pro-rata value based on total issued common shares (absolute control)	$100
Less: Minority discount (say 20%)	(20)
MMIV (as-if-freely-traded minority interest value)	80
Less: Marketability discount (say 40%)	(32)
Non-marketable minority interest value = Fair Market Value	$ 38

Hence, the minority shareholder in this example suffers a 62% effective discount.

The factors to be considered in quantifying a marketability discount include (but are not limited to):

- the holding period of the shares;
- dividend policy/cash distributions during holding period;
- the nature of the company;
- management;
- the degree of control, if any, comprised in the shareholding;
- restrictions on transferability;
- capital appreciation during holding period;
- the company's redemption policy;
- required holding period return;
- position in the industry; etc.

The accompanying slide, entitled "Control vs. Minority Positions in Private Companies", visually depicts the difference between a minority discount and a marketability discount. It distinguishes among control value, marketable minority interest value and non-marketable minority interest value, being the three possible levels of value.



2.3 Valuing Fractional Interest in Real Estate

Generally, pro-rata net asset values of undivided real property are discounted to reflect (a) lack of control and (b) lack of marketability, For a partial or fractional interest in real property, the disadvantages of lack of control are similar to those found in a corporation or a partnership, *viz.*, impediments to the unfettered ability to control the use of the assets or the cash flows from the assets. The marketability discount reflects the time and the cost to convert the interest to cash. However, unlike a corporate shareholding, the owner of a fractional interest in real property has the ability to seek partition, and therefore, control, of his or her proportionate share of ownership. A discount is often appropriate in view of the cost, uncertainty and delays attendant upon partition proceedings.

We note that the United States Internal Revenue Service ("IRS") had issued a *Tax Advisory Memorandum* relating to the discount for a 50% undivided interest in a property, stating that "the amount of any discount should be limited to the petitioner's share of the estimated cost of a partition[6] of the property".[7] The IRS also states, in its *Valuation Guide for Income, Estate and Gift Taxes*[8], that "…the smaller the [fractional] interest, the larger the discount … [and] the fewer owners, the smaller the discount, … ".

In an article appearing in *Business Valuation Review*[9] the author states that "our experience using the costs to partition valuation approach is that overall discounts from net asset value will be from 10% to 20% for even the simplest partition suit and from 30% to 35% or more on larger, more complex suits and/or larger properties … ".

The article concludes as follows:

> "Historical Tax Court decisions often have allowed some discounts from pro rata shares of net asset value for undivided real property interests. IRS's TAM 9336002 [above] suggest that the amount of discount should be the cost to partition. Careful examination of the partitioning process, and particularly the time required, demands substantial discounts from net asset value, as the cost to partition is often underestimated. The hypothetical willing buyer of an undivided interest must consider the substantial time and costs that could be required to gain control of the cash flow and to make the interest marketable".

Key factors in determining the discount include:

(a) The size of the fractional interest;

(b) Comparable sales of undivided interests, if available;

(c) The number of other co-owners of the property;

(d) The time required to realize an income from the property or to achieve return on the investment;

(e) The size of the tract, in the case of land;

(f) The time and cost to partition;

(g) Lack of management;

(h) Lack of liquidity.

2.4 Portfolio Discount

In valuing a company owning a substantial number of individual properties, securities or investments, it may be appropriate to apply a "portfolio discount" to the aggregate of the respective values of each of the items comprised in the portfolio. This reflects the fact that while the value of each property may represent, on an individual basis, the "highest price obtainable" (as contemplated in the term "fair market value"), the mix and quantity of the properties may result in the bundle *en bloc* being less attractive to a notional purchaser than each one viewed individually. While the notional purchaser is presumed to be attracted to the majority of the properties (since he or she is acquiring the issued shares in order to obtain control and ownership of the properties), the purchaser may likely wish to (imminently) dispose of the ones considered the least desirable. As there are risks and costs associated with any disposition, if the purchaser has paid fair market value (on the basis of the properties viewed individually), and subsequently realizes such amount on sale, there would be no economic return (ignoring the time value of money). Nor would a purchaser pay dollar for dollar for the assets. In fact, a notional purchaser acquiring a large portfolio of properties, comprised in the issued shares of the owner-corporation, should be able to negotiate a better price by being granted a "quantity discount" (because of buying "wholesale") as well as a further discount to recognize the risks relating to the more undesirable properties in the portfolio. Hence, the portfolio discount is a composite one (as is the minority/illiquidity discount above). The discount is applied to the aggregate value of the individual properties. This would recognize that, through a share transaction, the notional purchaser is acquiring the properties *en bloc*.

In *LoCicero et al.* v. *B.A.C.M. Industries Ltd.*,[10] a decision of the Manitoba Court of Queen's Bench, reversed by the Manitoba Court of Appeal,[11] the Supreme Court of Canada restored the decision of the trial court,[12] which had accepted that appraised values of individual parcels of land must be discounted for the following reasons:

- Appraisals of individual properties are unreliable indicators of the fair market values of shares of large real estate companies;
- The specific nature of each property, the assumptions on the economy, local markets or financing, and, most particularly, the size of a holding can vitiate the usefulness of any valuation technique used by real estate appraisers (replacement cost, comparable sales, or economic value);
- Appraisals do not reflect the varying capital structures of different companies; and
- Appraised values are in effect very spasmodic and ephemeral, and can be drastically reduced in only a few months.

A (portfolio) discount of 47% was applied to the appraised values of B.A.C.M. Industries Ltd.'s real estate to represent the "realities of the market" and the financial world, which discount would have reflected how the market viewed the appraised value of a substantial land bank during the 1970s.

In the U.S. decision *Estate of Greg Maxcy* v. *Commissioner,*[13] a portfolio discount of 15% was applied. The "pyramid principle" was explained as follows:

> [T]here is a large number of people that could buy one of the groves, one of the lots, or ore parcel, even the larger parcel of pasturage, but the likelihood, as you proceed upward in the pyramid of finding one person who would be interested in buying on the one hand a ranch, on the other hand [6,861] acres of pastureland, lots, [and] groves, is in the pyramid … and for this reason, any time you reduce the size of the market, you, without exception, encounter a discount in order to effect the sale.[14]

2.5 Preferred Shares

From an investment perspective, preferred shares (or "special shares"[15] in closely-held corporations) are fixed-income securities[16] having a predetermined, or contractually fixed, income (dividend) stream accruing to the holder, and do not generally participate in the growth of the business enterprise, unless they are convertible into common or participating shares. Emphasis is accordingly placed on the current and future income yield on the preferred shares, i.e., cash flow by way of specific, predetermined and periodic payments in the form of dividends and/or a series of redemptions, depending upon the specific rights, privileges, conditions and restrictions attaching to them. Some preferred shares may pay dividends into perpetuity (perpetual preferreds) or may have a maturity (redemption) date; others may provide the holder the right to request the redemption thereof (retractable preferreds). In summary, the key factor in valuing preferred shares is the degree of certainty in receiving future dividends or, in the case of retractable preferreds such as those used in an estate plan, receiving redemption proceeds if and when requested by the holder.

Apart from the basic rights (priority over the common shares as to dividends and assets), there are a host of possible additional features which can, individually or in combination, attach to preferred shares:

- Cumulative dividends;
- Voting rights, which could be shared *pro rata* with, or superior to, the common shares, or be fractional;
- The right to vote on a "special resolution"[17] to alter the rights of the shares;
- Redemption of the shares at the company's option, either at a specified point in time or at any time at a fixed or variable redemption price;[18]
- Sinking fund requirements providing for the redemption of the shares;
- Convertibility, i.e., the holder's right to convert the shares into common shares, or into preferred shares of another class, which right may be exercised usually during a specified period of time;
- Option or warrant entitling holder of preferred shares to purchase common shares at prices, in amounts and during periods, stipulated;
- Retraction (redemption or purchase at the option, or demand, of the holder, much like a promissory demand note);

- Participation, i.e., once their basic fixed dividend is paid, the preferreds may share in further distributions along with the common, either fully or with limitations, both as to dividends and upon dissolution;
- Exchanging (either into bonds of the issuer or common shares of an entity in which the issuer has a substantial interest);
- Provision making the particular class of shares senior to all other preferred classes (or subordinated to all or some of the preferred classes);
- The dividend, rather than being fixed, may be a function of the bank prime rate of interest (adjustable-rate preferreds).

As noted below, the rights, privileges, conditions and restrictions — coupled with the issuer's financial position and prospects — are essential factors to consider in the valuation of private-company preferred shares.

3. UNCOVERING HIDDEN ASSETS AND UNDISCLOSED INCOME

Problems arise, however, when the defendant attempts to hide assets and/or income or the relevant financial statements or income tax returns lack full and proper disclosure. In such situations, the plaintiff's accountant or business valuator must play the role of a financial sleuth and apply forensic accounting or and, his valuation techniques.

An article in *The New York Times* referred to the "forensic accountant [as] a financial detective who can track down the assets of the most miserly of husbands … ". A settlement in the State of New York of a U.S. $7.6 million marital estate of a Manhattan businessman involved fees of U.S. $275,000 for the business valuator/forensic accountant.

In many cases, the business valuation expert retained in divorce litigation, or shareholder and partner disputes, faces an uphill battle — and so do the courts — in trying to determine the facts and arrive at the truth.

A few recent judgements of the family law courts provide a shining example of the frustrations and challenges faced both by business appraisers and the courts. For example, the Quebec Court of Appeal unanimously affirmed the findings of the trial judge in a matrimonial matter which presented a host of impediments and challenges to any business valuator representing a wife in her claim for alimentary support.

This divorce case involved an array of financial, valuation and even forensic accounting expert evidence. Some of the comments of the trial judge are included below to show just how difficult and challenging a task the wife's valuation expert had to confront.

There were 22 days of trial with 14 persons testifying, including the opposing business valuators. The husband ("Monsieur") filed 115 exhibits and his wife ("Madame"), 90.

As the trial judge noted at the outset of the judgement:

> "This is an exceptional case; exceptional as to the meanness of the dispute, attributable to a very large extent to the conduct of [Monsieur].
>
> "The Court uses the word 'mean' on purpose; it has a double significance: 'nasty' and 'stingy'; the Court means both."

The following additional observations may help set the "flavour" of the frustrations of both Madame's business valuator and the trial judge.

Madame's business appraiser, a Chartered Business Valuator and Chartered Accountant, included the following Scope Limitation in his expert's report:

"We have been requesting … certain information and documents with respect to the various companies in which Monsieur owns shares directly and indirectly, including (but not limited to) Far East Trading Co. and Mexicana Corp. Notwithstanding numerous attempts to procure same, and that Undertakings were given by Monsieur, we have as of the date hereof still not been provided with such information or documents. These relate to a number of factors which would assist us in arriving at a more precise conclusion as to Monsieur's (a) net worth and (b) real income before tax, in order to help establish his financial ability to pay a lump sum and alimentary pension to Madame. It may be that such documents will be provided to us subsequent to the issuance of this report, in which case we reserve the right to provide additional evidence in respect thereof during the continuation of the proceedings, with the permission of the Court.

"We should also note that certain documents and information were requested during the out-of-court Examinations of Monsieur as well as during the trial [which had actually commenced one year earlier but had been suspended after four days of hearing]. In a number of cases, as they were neither available nor produced during these Examinations, they were to be provided through Undertakings. As of the date hereof, they have still not been produced by Monsieur. Those Undertakings relate principally to Monsieur's offshore assets, including (but not limited to):

- Shareholdings in Far East Trading Co.;
- Bank account(s) of Monsieur and of the said offshore company;
- Accounts in the Cayman Islands [which were revealed in earlier depositions]; etc.

"Accordingly, we reserve the right to revise our conclusions should such additional documents and/or information be provided to us prior to, or during, the continuation of the Court proceedings.

"By virtue of (a) management remuneration and other benefits emanating from Monsieur's companies being of a non-arm's length nature, (b) such amounts being largely discretionary and (c) there being substantial transactions in the Far East and Mexico with respect to which neither information nor documentation has been forthcoming, we arrived at Monsieur's *minimum* net worth and *minimum* real income.

"Production and disclosure by Monsieur of such documents and information would enable us to revise the conclusions arrived at herein and comment upon his financial position and earning capacity during the course of the proceedings."

Even the Court made the following observations after hearing the evidence:

> " … it was clear that [Monsieur] wanted a divorce on the terms he felt appropriate; when he realized it was not going to work out his way, he dragged his feet; he postponed; he was away on business and not available; documents were not provided; records did not exist; etc."
>
> …
>
> "What is clear, even striking, is the extent to which personal expenses were paid by the business, either directly, or indirectly, by cash, i.e., undeclared income generated by cash sales and, later, undeclared income from foreign business activities."
>
> …
>
> "Also, it is clear, as one goes through the credit card and travel statements, that [Monsieur] travels so much that most of his day-to-day expenses are carried by the business. It is true he maintains a home … , but he really is not there very much.
>
> "As to the amount or level of cash supported expenses, the Court does not accept [Monsieur's] testimony that there was never very much money in the home safe … .
>
> "[Madame's] testimony was that [Monsieur] brought cash home regularly and that there were thousands and thousands of dollars in the safe, which were available to her for the family's needs; both the second house … and the third house … had a built-in safe".

Madame's testimony was supported by a witness as well as by numerous exhibits illustrating the extent of *cash* payments for living expenses such as clothing, children's camps, private schools, a TV set, a refrigerator, furniture, etc., which all emanated from undeclared cash sales from Monsieur's business. As to the personal expenses paid through the business, evidence was provided regarding trips, purchases of furniture, household expenses, liquor, and company-purchased gift certificates at major department stores. As the Court stated:

> "In summary, the … family unit lifestyle was to a large extent made possible by undeclared income (cash in the safe) and company supported expenses. In other words, [Monsieur] had the business pay for many personal expenses either directly, by passing it off as a legitimate business expense, or indirectly, through the non-declared cash revenues; consequently, he could afford to have the business pay him a low taxable salary.
>
> "[Monsieur] himself confirmed this indirectly when he stated that company tax audits usually generated sizeable personal tax reassessments … ".

In addressing the financial and valuation issues, the Court was skeptical, to say the least, of the information provided by Monsieur:

> "In general, [his] testimony is to be examined with a very critical eye. He attempted to mislead the Court as to his capacity to pay. It took him a long time to realize that stonewalling, denying and not remembering would not work; for example, his interest in the [offshore] business; for example, the [offshore] bank account.
>
> "[He] says what he thinks he can get away with. For example, concerning his bank account [offshore], he gave three successive versions … ."

Evidence was filed with the Court, including faxes between Monsieur and his offshore company in the Far East (in which he had denied having an interest), referring to "my bank account and the bank book you are holding for me."

The judge then concluded: "[Monsieur] lied to the Court concerning his involvement in [the offshore company]".

While Monsieur denied that he owned an entity in the Far East, it was not until only a few weeks before the trial was scheduled to begin (which was three and one-half years after the launching of the divorce litigation), that he admitted that he "owned a few shares" and had been a shareholder for about five years.

Responding to Monsieur's claim that he was unable to obtain financial statements of his offshore company from his co-shareholder, the Court stated:

> "This is a very handy excuse: the refusal of the foreign partner … conveniently located in a jurisdiction sufficiently far away to make it improbable that any serious attempt would be made to verify [Monsieur's] representations. … the Court does not accept this explanation."
>
> …
>
> " … [Monsieur] is hard to pin down, even taking into consideration the fact questions related to events years past.
>
> "[He] appears to be incapable of answering a question clearly the first time it is asked; his answers are always hedged; they are couched in terms that prevent us from getting a clear and unequivocal answer: 'To the best of my recollection', 'I believe', 'I assume', 'I think', 'It was a long time ago'; he does not remember, he would have to verify, he would have to check, he can't recall, it is either one or the other, etc.
>
> "Moreover, in the vast majority of cases, a thorough and complete answer to a question only comes after three or four sub-questions are asked. In other words, a first question is asked and it is answered in a general, vague and hedged manner; this answer has then to be further refined by a series a sub-questions. But only when he is confronted with a document, something tangible, something he cannot refute, does [Monsieur] become forthright and his answers become clear.
>
> "Another pattern of [his] mode of testifying is as follows: he will first make a statement which is false and will then, at a later time, after the break, later in the same day, or the next day, or at the next series of days of hearing, rectify or amend or modify or amplify the first original statement".

The two opposing business appraisers had each produced various reports over a three-year period, opining on (a) Monsieur's net worth and (b) his (i) "disposable annual income", in the reports of Monsieur's valuator and his (ii) "minimum real income before tax" (so-called "notional income"), in the reports of Madame's business valuator. (Each successive valuation report was the result of information subsequently discovered; the first valuation reports were issued in mid-1989, with the latest reports being issued in the spring of 1994.) At trial, while each of the business valuators testified on the contents of his latest report, both experts nonetheless had to file various amending schedules because of yet additional information being produced and/or uncovered with respect to Monsieur's financial position and world income.

Even though Madame's forensic valuator had been able to identify shares in a Far East operating business as well as bank accounts, the absence of any financial statements or bank statements made it impossible to even attempt to attribute any values thereto.

3.1 Hidden Assets

The party being sued for a lump sum, equalization payment, or other amount in respect in family patrimony (depending on the particular jurisdiction) may be tempted to be less than forthright in listing, or disclosing, his or her assets.

There may be controlled assets which are situated in distant locations, perhaps offshore, and/or in the name of nominees, trusts, foundations, or other vehicles.

It is extremely difficult, at best, to trace such assets. The more time that the owner had in orchestrating his or her affairs in such manner as to become "insulated" or "judgement proof", the more difficult the task for the forensic accountant or business valuator. In such cases, it amounts to a game of "hide and seek", with the "seeker" often the one who is at a disadvantage.

As a starting point, the expert must request a host of documents and information which, if provided, would assist significantly in the investigation/discovery process or, as a minimum, provide important clues. Where there are offshore assets, particularly in such jurisdictions as Liechtenstein, The Bahamas, Grand Cayman, Bermuda, Turks and Caicos Islands (to name a few), the existence of documents, or indeed entities (such as foreign corporations and trusts, *anstalts*, etc.), may never be acknowledged or uncovered.

The accompanying appendices contain "questionnaires" or "checklists" to assist the professional accountant or business valuator in tracing assets and income of the party being sued and who attempts to hide assets and income. Each questionnaire or checklist must be tailor-made to the specifics of the case. As the plaintiff's attorney may include a number of these items on the subpoena *duces tecum* to be served on the defendant, it may be challenged (e.g., as to relevance) by the latter's attorney. Accordingly, the business valuator must be prepared, if called upon, to explain to a judge or justify why each specific item is relevant for purposes of the valuation analysis. A judge will rarely allow a "fishing expedition" to take place; thus, each document and piece of information must be relevant in the expert's attempt to paint a complete picture.

3.2 Undisclosed Income

The nondisclosure of income in an affidavit or other sworn statement filed with the court in divorce litigation is not only illegal, but, of course, would be an income tax offence to the extent the party's tax returns have also omitted to include taxable income.[19]

Income can be suppressed in various ways, the most common are (a) the omission (i.e., the non-recording or understatement) of gross revenues or receipts and (b) the artificial inflation of costs and expenses. Either of these methods, or a combination thereof, has the effect of reducing the bottom line, i.e., income, in a particular time period.

Typically, when confronted with proof of unrecorded cash sales, the "perpetrator" may take the position that such gross income amounts must be reduced (or even eliminated) to take into account cash expenses paid out of these funds. (For example, unrecorded cash was used to pay part-time help, certain suppliers, secret commissions, and so forth.) Nonetheless, the onus of proof is on the plaintiff to substantiate the defendant's alleged undisclosed cash or income. In the final analysis, a judge will have to weigh the evidence. Such evidence will likely be based on reconstructing records, etc. — not on first-hand or *prima facie* documentary proof — as the investigative accountant or business valuator does not have the "search and seizure" powers necessary to obtain documents, as do Revenue Canada and the RCMP. However, in many cases a Court Order might be obtained, requiring the defendant to produce relevant documents. The accountant or business valuator should therefore ensure that careful, meticulous, and logical documentation and explanation are presented to the court, excluding any items that may be considered by the court as mere speculation and conjecture.

The types of conduct, symptoms or improprieties noted during an examination or financial analysis of the defendant's records, which might trigger investigative work by the accountant or business valuator, include:

- Backdating of documents;
- Misleading characterization of transactions or items;
- Oral (rather than written) agreements;
- Creating documents;
- Offshore wealth;
- Use of nominees, frontmen, or *alter egos*;
- Step transactions or multiple financial steps;
- Unusual expenses;
- Alteration of records;
- Using cash instead of bank accounts.

3.2.1 Unrecorded Cash

We have heard such expressions as "unrecorded cash sales" or "under-the-table receipts". Typical examples include the omission of sales revenues, often where the customer, client, or patient does not require a receipt from the provider of the goods or services and therefore no document is created. Income is easy to hide when the payor settles an account with currency (or travellers' checks) rather than by check, which would otherwise leave an audit trail. Certain types of businesses have receipts largely in cash: liquor establishments, restaurants, bakeries, fruit and vegetable markets, grocery and convenience stores, various retail outlets, certain manufacturers, construction and home renovation companies. There are also some professionals who are notorious for running large cash operations, in that the client or patient often does not need a receipt.

The exclusion of gross revenues impacts the bottom line. Some business valuators may learn about unrecorded cash sales during the course of a valuation engagement with respect to the sale of shares in an open-market transaction. Occasionally the entrepreneur will sheepishly confess that there have been substantial unrecorded cash sales in the years under review and that this fact should be discreetly factored into the valuation. In addition to the omission of gross sales revenue, there may also be an understatement of inventory and/or an overstatement of operating expenses which the valuator may be asked to consider in preparing the valuation.

The disposition of the undeclared cash is generally as follows:

- Deposits in secret, offshore bank accounts.
- Deposits with stockbroker.
- Purchase of real estate, jewellery, furs, *objets d'art*, automobile, boat, furniture, appliances, stereo system, etc.
- Payments for vacations, non-deductible trips, meals, entertainment, golf and yacht clubs, renovations or painting of residence, gifts, etc.
- Payments for weddings and other functions.

Receipt of such cash by the payees, in settlement of the foregoing items, may trigger unrecorded cash sales from the payee's perspective. Hence, there is a "multiplier" effect. The "under-the-table" cash price is usually a better price, reflecting a discount granted to the payor which takes into account a portion of the income tax saved by the payee. It is not unusual to hear the story about some landscaping performed on a certain residential property. The landscaper's bill amounted to $2,600. When asked by the homeowner whether the landscaper would accept $2,000 in cash (with no receipt) in lieu of a cheque for $2,600, the landscaper replied, "No! $2,600 ***is*** the cash price!"

Other methods of improperly reducing, or disguising, income in a particular period relevant to the examination include:

- Characterizing income as capital;
- Deferral of the income inclusion;

- Diversion of income to another entity;[20]
- Bartering.

3.3 Costs and Expenses

3.3.1 Cost of Goods Sold

The difference between a company's sales and its cost of sales (cost of goods sold) represents gross profit. Hence, an understatement of Sales and/or an overstatement of Cost of Goods Sold will affect gross profit and, hence, taxable income. In Table 2, below, assuming that the only item affected is the Cost of Goods Sold, a $200,000 overstatement produces a $200,000 reduction in gross profit. In this example, by *understating* the closing inventory by $200,000 (i.e., from $1,300,000 to $1,100,000), there is an *overstatement* of the Cost of Goods Sold by an equal amount (i.e., from $6,000,000 to $6,200,000). As Gross Profit = Sales - Cost of Goods Sold, a Gross Profit of $3,800,000 results, rather than $4,000,000 (Table 1).

Table 1

CALCULATION OF NET INCOME — BEFORE AND AFTER SUPPRESSION

		Before Suppression	**After Suppression**
Sales		$10,000,000	$10,000,000
LESS:	COST OF GOODS SOLD (Table 2)	(6,000,000)	(6,200,000)
	GROSS PROFIT MARGIN	4,000,000	3,800,000
LESS:	OPERATING OVERHEAD		
	• Selling expenses	600,000	700,000
	• Administrative expenses	1,800,000	1,900,000
	• Financial expenses	400,000	400,000
	Total Overhead	2,800,000	3,000,000
NET INCOME BEFORE TAX		$ 1,200,000	$ 800,000

Table 2

CALCULATION OF COST OF GOODS SOLD

	Before Suppression	**After Suppression**
Inventory, beginning of year	$ 1,000,000	$ 1,000,000*
ADD: Purchases during year	6,300,000	6,300,000
Cost of goods available for sale	7,300,000	7,300,000
LESS: Inventory, end of year	(1,300,000)	(1,100,000)
Cost of goods sold	$ 6,000,000	$ 6,200,000

* Assuming it was not understated at end of immediately preceding taxation year.

The most common method used to inflate the Cost of Goods Sold is to understate the closing inventory of the business (e.g., establishing so-called inventory "reserves").

At the Cost of Goods Sold level, an alternative (or an additional) method for suppressing gross profit is to overstate purchases. There may be situations where phony invoices have been issued to the taxpayer by a dummy supplier, but no merchandise was actually shipped. In such cases, the company has obtained documentation (the supplier's phony invoices as well as the payor's cancelled checks) to support Purchases expense on its books. In return for issuing the spurious invoices to the purchaser, the dummy supplier would retain its "commission" out of the payment proceeds of the invoices.

3.3.2 Overhead Expenses

Where the nature of the business or practice does not lend itself to omission of gross revenues (through cash sales), it is more common for the perpetrator to inflate the expenses of his or her business operation.

3.4 Methods of Proof

The following four basic methods which may be used to uncover hidden income, depending on the nature of the nondisclosure:

- Net Worth Method
- Expenditures Method
- Bank Deposits Method
- Source and Application of Funds Method.

3.4.1 Net Worth Method

Under this indirect method of proving unreported income, the spouse is asked to produce personal balance sheets for a specified period of years. In simplest terms, as a starting point, income in a particular year will equate to (a) the increase in net worth during that year, as evidenced by a comparison of the personal balance sheets, and (b) expenditures made during the periods, other than for assets which would already be included in the calculation of net worth. The aggregate should represent the amount of unreported income for the taxation year under review, except to the extent that capital receipts gave rise to the increase in net worth.

Typical defenses to the Net Worth Method include:

- The plaintiff's business valuator has incorrectly calculated the opening net worth and the closing net worth which merely includes the discovery of assets already owned (and not included in opening net worth);
- Increases in net worth are from non-income sources; and
- The plaintiff's valuator has applied erroneous accounting procedures to calculate net worth.

3.4.2 Expenditures Method

This method considers the defendant's annual expenditures, instead of increases in net worth, to determine the real income.

The Expenditures Method is similar to, but not quite as thorough as, the Net Worth Method, in that the relationships among income, personal expenditures and increases/decreases in personal assets are the same under both methods. A defendant sometimes tries to account for the high level of expenditures by claiming that he or she is living off borrowed funds or the liquidation of personal assets. Documentation thereof is rarely forthcoming.

3.4.3 Bank Deposits Method

Applying this method, a presumption is made that all bank deposits and cash expenditures arise from income (rather than capital) sources, except as proven otherwise (e.g., gifts, loan repayments, lottery winnings, liquidation of assets, etc.). The opening cash on hand is determined at the very outset. Where large, single items are involved, the plaintiff's accountant or business valuator might apply the "specific item" method, i.e., identify the specific item such as the sale of real estate, loan proceeds, etc.

3.4.4 Source and Application of Funds Methods

Applying this method, the business valuator attempts to piece together the defendant's cash transactions so as to determine the unreported income. All known receipts and expenditures are calculated and a statement is made setting out funds received during the particular year and those expended in the year, with the opening and closing cash positions and the increase or decrease therein at year-end. Working backwards, the accountant or valuator will determine the net income and compare this with what was reported in the filings by the defendant in divorce court.

Under-reporting income and/or overstating expenses affects, among other things:

- The value of a business and, hence, a business ownership interest;
- The position of the company's shareholders;
- The position of future investors in the company;
- The position of the company's creditors;
- The position of the company's future lenders;
- The position of the (divorcing) spouse of a shareholder;
- The public treasury.

I read an article in *FairShare* a few years ago about a forensic valuator in a matrimonial matter who was investigating a basic delicatessen operation which catered to a breakfast and lunch crowd and derived most of its income from the sale of pastrami, corned beef and other sandwiches as well as coffee and various small grocery items. With the husband-owner being sued for alimentary support, and being the type of cash business that it was, not everything was recorded in the deli's books.

The business appraiser's client, the deli owner's wife, tipped off the appraiser that there were two cash registers with the proceeds of only one being reported. When confronted by this allegation, the husband acknowledged that he had two registers but one was "inoperable". He did, however, comply with the accountant's request for a copy of the cash register tapes from the register that was operable. These tapes tied into the income reported on the husband's tax return.

However, a physical visit to the deli by members of the valuator's firm revealed that both registers were being actively operated. The husband, during his interview with members of the valuation firm, explained to them how much product goes into the sandwiches. Subsequently, other members of the valuation firm whom the husband had not seen before, went to the deli and ordered a few sandwiches to take out. The valuators took the sandwiches back to their office where they dismantled and weighed them on two separate postage scales. On this basis, they were able to calculate the cost of the ingredients that went into the sandwiches. This was used as a model for determining (at least with respect to the sandwich portion of the business) gross profit. The respective gross profits from other segments of the business were determined by applying other methods.

In reconstructing the cost of a sandwich, a breakdown was made as among:

- The roll;
- Meat (in ounces);
- Cheese (in ounces);
- Tomato, lettuce, oil and vinegar.

Naturally, different types of sandwiches have different ingredients and adjustments would be made as appropriate.

Having estimated the cost of a sandwich and knowing the selling price from the menu, the cost percentage can be determined which, when viewed in the context of the total business, can yield the weighted average cost percentage. For example, if the aggregate cost of the ingredients were $1.80 and the selling price of the sandwich $3.50, the cost ratio would be 51.4%. Assuming that sandwich sales equal 45% of the business, the weighted average cost ratio would be 23.13% (45% x 51.4%).

Separate calculations were made by the valuators with respect to potato chips and packaged cakes, soft drinks, cigarettes, milk, grocery and sundry as well as coffee. For example, the calculation with respect to coffee was analyzed on the basis of the number of packages and the yield in terms of cups (e.g., 80 packages yielding 560 cups). Milk, cream and sugar would be factored in so that a cost of 560 cups of coffee could be determined and, in a manner similar to that with respect to the sandwiches, a weighted average cost ratio could be determined. (Based on discussions and a review of various data, it was assumed that coffee comprised 6% of the total business.)

Finally, an "error rate" and "wastage allowance" was calculated at 6% of cost in arriving at the "reconstructed cost of goods sold as a percentage of total sales". This percentage was then applied to the total cost of sales during the period under review in order to determine estimated total sales, as reconstructed from the cost of goods sold. For example, if total cost of goods sold for a nine-month period is $150,000, and the cost of goods sold as a percentage of total sales is, say, 65% (based upon the weighted average cost ratio determined earlier), estimated total sales would then be $230,770. If reported sales for the period are $186,000, then implied unreported sales would be $44,770 ($230,770 - $186,000). For the full twelve months the implied unreported sales would be 12/9ths or $59,690. The matter was settled.

Incidentally, having two (or more) cash registers) with one (or more) being used for unreported sales, as in the "deli case", is not unique. For example, in an oppression remedy case (which involved a retail video store operation), the judge commented as follows:

> " … It is also in evidence and not contradicted that, in the operation of the business, two cash registers were used, one primarily for VHS cassettes and the other for Beta cassettes. Apparently it was agreed between the three partners that the Beta cash register would be used for unrecorded cash receipts and also by the partners in order to withdraw cash from the business. It also appears that certain expenses were paid from the receipts in this cash register. It is also in evidence and uncontradicted (and I must assume that this figure is correct), that each of the three shareholders withdrew from this cash register a sum of approximately $8,000 during the period aforementioned in partial repayment of the loans of $30,000 which each of them had made, leaving a balance owing to each partner of approximately $22,000."

Assuming that the forensic business appraiser is confronted with a similar situation, where complete disclosure is not forthcoming (whether in a divorce matter, shareholder dispute, or other purpose), the appraiser must, in effect, "construct" or "reconstruct" the financial statements of the subject enterprise and this is only a starting point.

ENDNOTES:

(1) Defined as an individual whose contribution to a business is so significant that there is certainty that present earning levels will be adversely affected by the loss of the individual.

(2) S.P. Pratt, DBA, CFA, FASA, *Valuing a Business* (Second Edition), Dow Jones-Irwin (Homewood, Illinois: 1988), p. 59.

(3) S.P. Pratt, R.F. Reilly, R.P. Schweihs, *Valuing A Business* (Third Edition), Irwin Professional Publishing (Chicago: 1996), p. 46.

(4) Jay B. Abrams, MBA, CBA, "Discount for Lack of Marketability, A Theoretical Model", *Business Valuation Review*, September 1994, (Vol. 13, No. 3), American Society of Appraisers, p. 136.

(5) Robert E. Moroney, "Most Courts Overvalue Closely-Held Stocks", *Taxes*, March 1973, p. 154.

(6) The two major factors in determining the cost to partition are (a) the time required for each element of the process (not simply the court time) and (b) the legal and other expenses involved during that time. Where significant disagreements exist among the parties and where lengthy negotiations and the use of additional professionals are required, the costs and time could be much greater.

(7) Tax Advisory Memorandum 9336002.

(8) CCH, 1994, p. 923.

(9) Ronald M. Seaman, ASA, CBA, "Valuation of Undivided Interest in Real Property", March 1997, (Vol. 16, No. 1), p. 32.

(10) See, for example, R.M. Wise and L. Racette, "Don't Discount Those Discounts", *CA Magazine* 122, 10 (October 1989).

(11) (1986), 25 D.L.R. (4th) 269; (1986), 38 Man.R. (2d) 134; [1986] 3 W.W.R. 152.

(12) [1988] 1 S.C.R. 399.

(13) 28 T.C.M. 783.

(14) At 792.

(15) The terms "preferred share" and "special share" are used interchangeably in the comments which follow. They are distinguished from common shares.

(16) While classified as "fixed-income" securities, the dividend rate may be specified as a fixed rate, an adjustable rate or a variable rate.

(17) Defined in subsection 2(1) of the *Canada Business Corporations Act* ("CBCA").

(18) CBCA, Section 36. The redemption price may not exceed the redemption prices stated in the articles or calculated according to a formula stated in the articles.

(19) The Internal Revenue Service has published materials on specific industries which are coming under particular scrutiny by IRS agents. These materials are published as IRS "Market Segment Specialization Program Audit Technique Guides", designed specifically for training purposes only; they do not establish or sustain a technical position. Appendix B lists those Guides which have been issued to date. The IRS also publishes a *Handbook for Special Agents.*

(20) The taxpayer might divert income to another entity, usually a foreign dummy corporation or an anstalt in a tax haven (e.g., Liechtenstein).