

— Advocate'sEDGE —



Be reasonable

How business compensation can affect divorce cases

FLP update

**Court sides with IRS over
bona fide business arrangements**

**Are your clients prepared
to handle a fraud disaster?**

When settlement proceeds are taxable

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How business compensation can affect divorce cases

When a divorcing spouse owns or is a partner in a closely held business, its value — particularly the amount of compensation the business provides to its owners — can play a significant role in the divorce case's financial outcome. Whether you represent the business owner or his or her spouse, you'll need a professional valuator to determine reasonable compensation.

VOICE OF REASON

How owners' compensation is calculated can dramatically affect property settlements and support payments.

For example, Larry owns a construction company and decides to claim an excessive salary to reduce the business's value and, in turn, the amount of the property settlement. Or, in a different scenario, Larry claims an artificially low salary to reduce alimony and child support obligations.

If the business consistently pays below-market rates for other employees, an above-market rate for an owner may be unreasonable.

Ideally, reasonable compensation for an owner of a closely held business like Larry's is the compensation he would be paid in an arm's-length transaction for the services he performed. A valuation expert would, therefore, determine the amount that a hypothetical replacement employee would be paid to perform those same services. Reasonable compensation needs to reflect the services rendered and shouldn't be confused with distributions of the business's earnings.



EVERY OWNER IS UNIQUE

Valuators weigh a variety of factors when determining reasonable compensation for a specific owner. Using the previous example, experts would look at an owner's:

Role in the business. It's essential to look beyond job title. A law firm, for example, may employ numerous "partners," but they don't all fill the same roles. Some are rainmakers, while others fight in the litigation trenches or manage the firm's operations. A valuator considers the experience and qualifications *necessary* to fill the partner's specific job, as opposed to simply the qualifications the partner happens to possess.

Compensation relative to comparable positions. The compensation received by similarly situated employees at similar companies is often useful. Valuators gather such data from a growing collection of sources, including the Bureau of Labor Statistics, the Medical Group Management Association, the Economic Research Institute and professional associations.

Company's internal consistency. How does the owner's or partner's compensation compare with

that of the business's nonowner employees? If the business consistently pays below-market rates for other employees, an above-market rate for an owner may be unreasonable.

Business characteristics and condition. The business's size, complexities, industry, competitive position, financial condition and history all bear on the reasonableness of compensation. Companies with a long record of high revenues from loyal customers generally can afford to pay high compensation. But smaller companies might pay a significant salary premium to woo those same employees.

Business location. A technology-based firm located in an urban area will probably have greater access to comparable employees than a similar company in a rural area. The cost of living is relevant, too. An owner in San Francisco requires more compensation than an owner in Anchorage to maintain a similar standard of living.

PROFESSIONAL PRACTICES REQUIRE MORE

When determining reasonable compensation for a partner in a professional practice, valuers consider some basic variables. These include the type of professional services offered (such as tax, estate or financial planning) or medical practice specialty, and the duration of the partner's practice.

Other factors might be the:

- ▶ Age and health of the partner,
- ▶ Hours worked and general productivity,
- ▶ Practice's market, and
- ▶ Number of locations in which the practice operates.

Management or administrative responsibilities handled by the practice partner will also play a role in determining reasonable compensation.

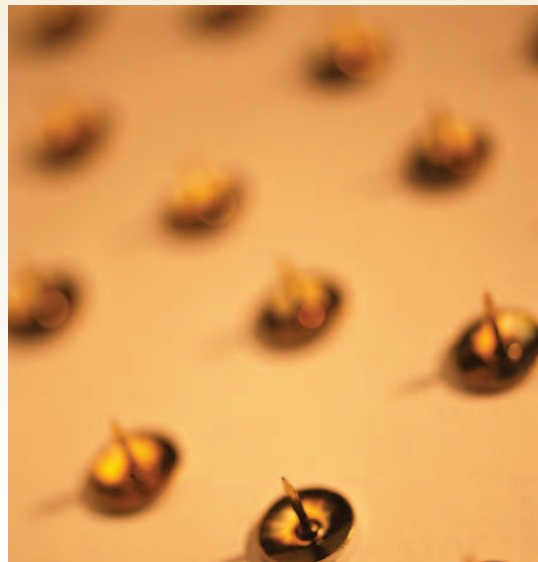
REASONABLE DOUBT

Keep in mind that what might at first glance appear reasonable may turn out to be anything but. Retain a qualified valuator to assess any owner compensation that could affect the outcome of a divorce case. ▶

POKING HOLES IN COMPENSATION TESTIMONY

Not all testimony carries equal authority. Whether preparing your own experts or working to challenge opposing experts, you need to consider several issues that will affect the credibility of their testimony on reasonable compensation. These include:

- ▶ The source of data used to form the expert's opinion,
- ▶ Whether the data has a regional or national scope,
- ▶ The sampling sizes,
- ▶ Whether the data provides means (average values) or medians (middle values),
- ▶ Whether the data includes owners whose compensation is made up of both straight compensation and business profits,
- ▶ How the data defines job titles — whether the duties used in the definition are sufficiently similar to those of the spouse,
- ▶ How the data defines the companies — whether the company characteristics used in the definition are sufficiently similar to those of the company in the case, and
- ▶ Whether the data includes stock compensation and other perks comparable to those received by the spouse.



FLP update

Court sides with IRS over bona fide business arrangements

Family limited partnerships (FLPs) offer advantages for some taxpayers, but the IRS continues to challenge these arrangements on several theories. In one case that made it to the Eighth Circuit Court of Appeals, *Holman v. Commissioner*, a split panel of judges sided with the IRS. The 2-1 panel held that, because the FLP at issue didn't satisfy the "bona fide business arrangement" requirement of Internal Revenue Code Section 2703, its transfer restrictions shouldn't be considered when calculating the valuation discount for shares of the FLP.

VALUING TRANSFER RESTRICTIONS

Under Sec. 2703, a transfer restriction can only be considered for valuation purposes if the restriction:

1. Is a bona fide business arrangement,
2. Isn't a testamentary device to transfer property to family members for less than full and adequate consideration, and
3. Has terms that are comparable to similar arrangements entered into by persons in an arm's-length transaction.



If restrictions don't satisfy all three requirements, the court suggested, they could minimize the tax consequences of gifts or transfers without imposing substantial additional limitations on the transferability or use of the property. This is especially likely in the context of family transfers, where a donor may hold some degree of practical control over a recipient's actions — even in the absence of formal restrictions — and where transactions often aren't arm's length.

HOLMAN FAMILY GIFTS

Thomas and Kim Holman created an FLP, funded it with common stock of Dell, Inc., and gifted limited partnership shares in the FLP to their children. In a gift-tax return, the Holmans applied discounts for lack of marketability and lack of control and claimed a value for the gifts that was substantially lower than the value of the underlying stock. They based the discounts in part on transfer restrictions in the partnership agreement, which they asserted would reduce the value of the partnership shares relative to the value of the stock.

The IRS applied Sec. 2703 and disregarded the transfer restrictions for valuation purposes. The Tax Court agreed, finding that the restrictions weren't a bona fide business arrangement. It also found that the restrictions *were* a testamentary device for transferring property. (The Tax Court didn't address the third requirement.) It reduced the discounts, thereby increasing the taxable value of the FLP shares.

EIGHTH CIRCUIT CONSIDERS THE CASE

The Eighth Circuit held that the Tax Court correctly assessed the personal and testamentary nature of the transfer restrictions, and it found no "business," active or otherwise, in the case.

The court didn't rule that investment-related activities can *never* satisfy the bona fide business arrangement requirement. But when transfer restrictions apply to a partnership that "holds only an insignificant fraction of stock in a highly liquid and easily valued company with no stated intention to retain that stock or invest according to any particular strategy," it's not difficult for a court to determine that they don't represent such an arrangement.

According to the Holmans, the FLP was set up to teach their children financial responsibility — a nonbusiness purpose.

The court described the Holman FLP as a "mere asset container" and noted that the Holmans didn't claim to have any particular investment philosophy.

According to the Holmans, the FLP was set up to teach their children financial responsibility — a nonbusiness purpose. Further, the partnership agreement didn't require the general partners to retain the Dell stock held by the partnership, and the Holmans apparently intended to diversify their investments. The taxpayers admitted that holding Dell stock as the FLP's exclusive asset wasn't part of an overall, long-term plan.

A TAXING VERDICT

The Holmans had claimed a combined lack of marketability and control discount of about 50%. But the Eighth Circuit affirmed the Tax Court's discounts of 12.5% for lack of marketability and 4.63% to 14.34% for lack of control, as proposed by the IRS's expert.

The dramatic difference in final taxable amounts demonstrates the importance of properly structuring and operating an FLP. Taxpayers also are encouraged to have their FLPs appraised by an experienced professional valuator. ▀

Are your clients prepared to handle a fraud disaster?

Most companies have a disaster contingency plan — a set of policies and procedures that management and staff are expected to follow in the event of fire, flood, hurricane, earthquake or other catastrophic event. Disaster contingency plans enable businesses to protect employees, minimize losses, and get up and running again as quickly as possible.

Fraud contingency plans protect companies in much the same way. But few businesses have considered — let alone documented — what they'd do if they found employees embezzling funds, stealing inventory or fudging financial statements. Don't let your clients

fall victim to financial and legal disaster: Encourage them to plan for the worst.

PLAN AS ROADMAP

A fraud contingency plan works as a roadmap to help a business minimize damages, protect evidence, maintain client relationships and even deal with the media during a stressful time. It sets objectives such as recovering losses, identifying and punishing the perpetrator, and deterring future fraud.

This plan also addresses immediate needs such as ensuring that business continues as usual during the

fraud investigation and outlining steps to rectify any losses from the incident. To catalog losses, your client would need to take an immediate inventory of assets and evidence — which means retaining a fraud investigator as quickly as possible.

AVOIDING KNEE-JERK REACTIONS

When a company discovers fraud, it should refrain from immediately firing the suspect. Instead, your client might suspend the employee until it's reasonably certain that the:

- ▶ Suspect was responsible for the fraud,
- ▶ Suspect acted alone,
- ▶ Full extent of the fraud is known, and
- ▶ Stolen funds have been located and can be recovered.

In any event, your client will want to get the suspect off the premises so his or her office or workspace can be searched.

This is where a contingency plan must be specific. While an initial examination of documents and personal papers may reveal certain ambiguities and irregularities, your client must know when to call an expert.

Contingency plans address immediate needs such as ensuring that business continues as usual during the fraud investigation.

Forensic accountants and computer experts understand what proof is required for legal action. More important, they know how to extract that proof without destroying its evidentiary value. An expert review of electronic files, for example, could damage user logs or file access data that might prove the suspect opened the incriminating records.

Likewise, fraud investigators are experienced in interviewing suspected perpetrators. They ask



questions and understand technical obfuscations that a business owner or manager might miss, and they conduct the interview in a way that helps establish its validity in court.

EVERYONE ON THE SAME PAGE

Any fraud contingency plan must receive a stamp of approval from the company's upper levels, including its board of directors. It must clearly delineate actions to be taken, establish limits on the internal investigation team, and identify how and when outside investigators, including police, will be called in.

Some fraud incidents may seem too minor to require full mobilization of a company's contingency plan. Unfortunately, a "small" fraud often can reveal the tip of a much bigger iceberg. Even if a theft seems inconsequential, putting the contingency plan into action helps ensure that a company uses its best practices and avoids costly mistakes.

PROACTIVE APPROACH

Too many companies wait until they've become victims before they put a fraud contingency plan in place. Instead, your clients need to not only plan for the best with strong internal controls and regular audits, but also to prepare for the worst with a fraud contingency plan. ▶

When settlement proceeds are taxable

The Sixth Circuit Court of Appeals has affirmed a Tax Court ruling that settlement proceeds received for false imprisonment aren't excludable from taxable income under Internal Revenue Code Section 104(a)(2). The opinion in *Stadnyk v. Commissioner* offers a valuable reminder of the two-pronged test for exclusion of income.

SOME BACKGROUND

Brenda Stadnyk was falsely imprisoned after her bank incorrectly marked her check to an auto dealer as refused for insufficient funds. The dealer filed a criminal complaint against her for issuing and passing a worthless check, and she was arrested and detained for about eight hours. Stadnyk sued Bank One for false imprisonment, among other claims, and the case settled for \$49,000.

Sec. 104(a)(2) allows taxpayers to exclude from income "the amount of any damages received (whether by suit or agreement and as lump sums or periodic payments) on account of personal physical injuries or physical sickness." But the U.S. Supreme Court has held that a taxpayer must show that:

1. The underlying cause of action is based on tort or tort-type injuries or sickness, and
2. The damages were received on account of personal injuries or sickness.

The second condition requires solid evidence of a direct causal relationship between the asserted personal injuries and the settlement.

SETTLEMENT AT ISSUE

The record surrounding the settlement didn't provide any insight on the claims that gave rise to the settlement. So the court turned to Stadnyk's complaint, which alleged a number of tort claims. The first test was therefore satisfied.

But Stadnyk failed to show that she sustained the claimed damages according to the second condition. She testified that she didn't suffer any physical injury as a result of her arrest and detention. All of the damages Stadnyk sought from Bank One were stated in terms of recovery for nonphysical personal injuries — including emotional distress, mortification, humiliation, mental anguish and damage to reputation. As the court noted, "These are all emotional injuries and are thus not excludable under Section 104(1)(2)."

Further, the settlement agreement didn't include any express language indicating that Bank One paid the settlement *on account of* any physical injury. The "on account of" language in the provision requires that damages be awarded *because of* a personal physical injury. A mere "but-for" link doesn't suffice because it would bring virtually all personal physical injury lawsuits under the Section. After all, but for the injury, no lawsuit would exist, and but for the lawsuit, no damages would be paid.

ACCURATE ADVICE

It's worth noting that Stadnyk claimed her attorney had assured her the settlement proceeds wouldn't be subject to income tax. Don't make that mistake with clients who receive settlements: Talk with a tax expert first. ▶

