



Two Landmark Cases Still Offer Reasonable Compensation Guidance

Two landmark court cases still provide attorneys, CPAs, and appraisers a robust analytical framework to assess reasonable compensation in family law issues.

1. *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983). This was the first case to articulate the “independent investor” standard and remains the leading authority in the Ninth Circuit (U.S. Court of Appeals). Federal courts still apply the *Elliotts* five-factor analysis to determine reasonable compensation for the owner/employees of small to mid-sized closely-held firms. These five factors are:

- Employee’s role in the taxpaying company
- Comparison of the employee’s salary to those similar companies pay for similar services
- Character and condition of the company (size, complexity, general financial condition)
- Any existing conflict of interest
- Internal consistency of the company’s payments to employees

2. *Mad Auto Wrecking v. Commissioner*, T.C. Memo. 1995-153 (1995). The Tax Court enumerated the following factors to judge the reasonableness of shareholder compensation:

- Employee’s qualifications
- Nature, extent, and scope of the employee’s work
- Size and complexity of the employer’s business
- Comparison of salaries paid with the employer’s net and gross income
- General economic conditions
- Comparison of salaries with distributions to shareholders and retained earnings
- Prevailing rates of compensation for comparable positions in comparable companies

- Employer’s salary policy as to all employees
- Compensation paid in prior years
- Employer’s past and present financial condition
- Whether employer and employee dealt at arm’s length
- Whether the employee guaranteed the employer’s debt
- Whether the employer offered the employee a pension and/or profit-sharing plan
- Whether the employee received business expenses reimbursement

The adjustment for reasonable compensation—whether in corporate practice or when conducting a business valuation—is one of the most difficult adjustments to quantify. Companies and legal counsel can still refer to *Elliotts* and *Mad Auto Wrecking* (as well as precedent in the relevant jurisdiction) for the important factors to consider.

Round up: Recent Cases on Business Interruption Losses

Two recent decisions highlight the best (and worst) in expert valuations of business interruption losses.

Insurance company provides credible estimate. After a summer storm damaged a Georgia motel, the owner hired an adjuster, who estimated repairs would take three months. The adjuster also calculated over \$300,000 for 12 months of lost business revenues. A CPA for the insurance company, however, calculated five months of “diminished occupancy” losses totaling

just over \$37,000, and the hotel sued for breach of contract and the insurance company moved for summary judgment.

In *B.S.S.B., Inc. v. Owners Insurance Co.*, 2010 WL 320229 (M.D. Ga. 2010), the court examined the insurance policy, finding coverage for business losses ended on the date the insured “could” have reasonably restored operations (not when it finally did restore operations). Since the hotel’s adjuster originally estimated repairs at three months—and the insurance company supplied five months’ lost revenues—the only way the hotel could survive summary judgment was by proving business losses in excess of \$37,000 for three months. The hotel offered its adjuster’s projected revenue report in addition to tax bills, but the court found problems with both.

First, the hotel’s adjuster used only two years of historic revenues when he should have looked to at least three. Second, the hotel’s tax returns failed to show precisely how its revenues would have exceeded \$37,000 during the three months following the storm, when it lost more than \$37,000 in 2005 and posted net profits of roughly \$5,000 in 2005. “Any award of lost profits under the policy is generous,” the court concluded in granting summary judgment and dismissing the hotel’s claims.

Insurance company proves not so credible. In the wake of Hurricane Katrina, the owner of a nursing home requested \$609,000 for repairs and business losses. The insurance company disputed coverage and finally, more than two years after the storm, cut a check for a mere \$1,150.

The nursing home sued for breach of contract and presented expert evidence of its lost profits. The insurance policy limited net business income losses (before taxes) to \$600,000 for a maximum of 120 days. With these limits in mind, the nursing home’s expert reviewed the facility’s historic revenues, which had been rising right up to the time of the storm, and also its general ledger. Applying “accepted accounting principles,” he concluded a four-month net income loss of nearly \$529,573.

After hearing from the insurance company’s expert, the jury ultimately awarded business interruption damages in the precise amount determined by the nursing home’s expert, and the insurer appealed. On review, the appellate court found the jury chose the methodology and analysis offered by the expert it believed to be most credible and confirmed its award.

Close Call: Taxpayer Appeals FMV Standard and Discounts in Valuing FLP Restrictions

The Holmans created a family limited partnership (FLP) to preserve their substantial holdings of Dell stock for their children—in particular, to protect against the claims of creditors (including divorcing spouses) and to encourage wealth management skills. To this end, the FLP precluded transfers to outside parties and gave the partnership the right to redeem any proposed sales.

In *Holman v. Commissioner*, 130 T.C. No. 12 (2008), the IRS argued—and the Tax Court found—that the transfer restrictions did not serve a bona fide business purpose under IRC Sec. 2703, but were merely a device for the parents to gift highly liquid Dell stock at reduced values. The Tax Court also adopted a 12.5% marketability discount, based on the IRS expert’s review of restricted stock studies as well as the FLP buy-back provisions, which acted as a natural “cap” or limit to any potential discount. In *Holman v. Commissioner*, 2010 WL 1331270 (C. A. 8 2010), the taxpayers appealed both aspects of the decision.

Hypothetical buyers or Holman buyers? The taxpayers claimed the Tax Court’s definition of “bona fide business arrangement” was too limited, effectively requiring the FLP to be an active, operating business. Instead, the taxpayers’ specific intent, as provided in the partnership agreement, should control. The nature of the assets is irrelevant, they said; the FLP was “an enterprise with the business purpose of generating profits through long-term growth.” The taxpayers also argued that the Tax Court’s construction of the buy-back provisions violated the fair market value (FMV) standard of the hypothetical buyer/seller by asking what the *particular* partners in this case would do if faced with a proposed assignment of FLP shares.

The U.S. Court of Appeals for the Eighth Circuit disagreed on both points. First, “context matters” when determining whether a restriction constitutes a bona fide business arrangement, the court held. The FLP was not a business, “active or otherwise.” Moreover, the underlying Dell stock was easily valued and highly liquid, and the taxpayers did not have any particular investment strategy or skill. By burdening an otherwise

liquid asset, the FLP was as a “mere container” to further a tax avoidance scheme.

As to the marketability discounts, in this case a hypothetical buyer would know that the FLP permitted the partners to buy out an exiting partner at little or no economic risk, given the liquid nature of the assets. Under these facts, the question became what the partners would reasonably do when faced with a pending sale of FLP interests at a steep discount relative to net asset value. “Simply put, the Tax Court did not ascribe personal non-economic strategies or motivations to hypothetical buyers,” the court ruled, in affirming the decision; “it merely held that, presented with the opportunity, rational actors would not leave money on the table.”

Note: A single judge on the panel dissented, finding the FLP restrictions served a legitimate business purpose and the court’s determination of marketability discount violated the fair market value standard.

Round up on Divorce Cases: Discounts, Valuation Dates, & the Economic Downturn

Is the severe economic downturn sufficient reason for a divorce court to revalue business assets? Does the statutory fair value standard preclude marketability and minority discounts in divorce? And what happens when a trial court combines the income and market approach to valuing a business? The following four recent divorce cases answer these questions and more.

An unprecedented recession. In *Mistretta v. Mistretta*, 2010 WL 547149 (Fla. App. 1 Dist)(Feb. 18, 2010), the trial court valued the parties’ restaurant at \$845,000, based on expert appraisals conducted in 2007. Not long after the divorce was final, the husband filed a motion to reconsider. The economic recession caused the restaurant to lose nearly \$57,700 in 2008, the husband claimed, and this “newly discovered evidence” merited a new trial and valuation. The trial court granted the motion, finding the 2007-2008 recession was “totally unforeseen.”

The wife appealed, arguing that the economic downturn was merely a change in circumstance, and

the appellate court agreed. Business valuation is a forward-looking exercise, based on financial facts currently in existence as well as projected revenues and cash flows. “Economic recessions, like other vagaries in the business cycle, are contingencies appraisers must take into account in valuing a business,” the court said. Although no valuation expert could have predicted the severe economic crisis, the trial court’s order did not explain why, on rehearing, these same experts were more likely to accurately predict future economic conditions. “A cloudy crystal ball is no basis for a new trial,” the court held, and it denied the motion.

Application of discounts and the statutory fair value standard. In *Lemmen v. Lemmen*, 2010 WL 454959 (Mich. App.)(Feb. 9, 2010), the husband owned a minority (25%) interest in a profitable, privately held oil and gas business with his brothers. The husband’s expert valued his interest at \$5.5 million; the wife’s expert said it was worth \$17.5 million.

The trial court rejected the husband’s valuation expert, finding that he incorrectly applied a discount rate to the company’s dividend stream rather than net cash flows. This left testimony from the wife’s expert, who declined to discount his \$17.5 million value for lack of marketability or lack of control because the company enjoyed exceptionally strong cash flows, low debt, and a substantial cash base. Four years prior to the divorce, however, the same expert had valued the same company for one of the co-owners, applying a 25% minority discount and a 30% marketability discount. He did so only at the behest of the lawyers, the expert explained; it was not his general practice to discount the valuation of closely held stock. Nevertheless, the trial court applied the expert’s prior discounts to his current valuation in divorce, and valued the husband’s 25% interest at \$11 million. Both parties appealed.

The appellate court deferred to the trial court’s broad latitude to determine the value of stock in closely held corporations and accepted its valuations, including discounts. It also rejected the wife’s arguments that the statutory fair value standard should apply to divorce cases. One judge on the panel dissented, which may set the case for an appeal to the state Supreme Court.

Emphasis on the correct date. In *Goodwin v. Goodwin*, 2010 WL 669244 (Tenn. App.)(Feb 25, 2010), the parties owned and operated a steel detailing business together. The husband’s expert

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valued it at \$385,000, excluding goodwill. Importantly, he valued the company as of the date the wife stopped working for the company as a bookkeeper, in 2007, and the husband took over sole operations.

By contrast, the wife's expert concluded that the steel business was worth \$1.65 million, valued as of December 31, 2008—just months before the parties' trial. After considering the evidence and applicable law, the trial court adopted the value as calculated by the wife's expert, and the husband appealed.

Resolving such a wide range of values is “one of the main roles of a trial court,” the appellate court said. A trial court is free to value a marital business within the range of evidence presented, and “that is exactly what [this] court did.” Further, state law requires valuing a marital business as close as “reasonably possible” to the date of trial. Since the wife's expert valuation was 19 months closer to this date than the husband's, the wife's evidence was more in line with the law, and the appellate court confirmed the lower court's \$1.65 million valuation.

A mix of valuation methods. *In Rozenman v. Rozenman*, 2010 WL 845924 (Ariz. App.) (March 11, 2010) (unpub.), the husband owned a separate cigar business, which appreciated during the marriage (2003-2008). As a start value, the trial court adopted a net asset valuation of the business at \$177,000, not because an asset value is generally superior to an income or market approach, it said, but simply because it was the only evidence available.

The parties each presented experts to value the business at the end of the marriage. The husband's expert relied on a net asset approach (\$274,000); he also applied a market approach (\$518,000) but said it wasn't “financially feasible.” By contrast, the wife's expert preferred the market approach because the comparables were good and the method adequately

accounted for the business's strong, ongoing operations, its workforce, and goodwill.

The trial court adopted the market approach by the husband's expert (\$517,800) and the husband appealed, claiming the court should have adopted a net asset value to measure the business both before and after the marriage. Under the circumstances, however, the rationale of the trial court was reasonable, the appellate court held, especially given the lack of market analysis for the start-up business at the beginning of the marriage.



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