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In This Issue

- **Changing Tax Rates—
Changing Value**
- **Family Limited Partner-
ships and the Courts—An
Update**
- **Breach of Contract**

CHANGING TAX RATES—CHANGING VALUE

The value of a business is equal to the present value of the future benefits of ownership of that business. Business valuations of operating companies are often based on projected net cash flows to the shareholders. Since Uncle Sam participates in the bottom line up to 40%, it is axiomatic that a change in tax rates will result in a change in the value of a business.

Incorporated businesses that are taxed under subchapter C of the Internal Revenue Code (so-called C corporations) are subject to a corporate level federal income tax, the brackets for which range from 15% to 38%. State tax rates are in addition. A C corporation pays dividends to its shareholders out of after-tax income. Such dividends paid are taxed to the shareholder as well, at a maximum federal rate right now of 15%. The value of a business is determined in substantial part by the amount of disposable income remaining with the shareholder—that is, the amount of spendable income retained by the shareholder after all taxes are paid. This simple principal is demonstrated by the difference in yields of tax exempt bonds versus taxable bonds of the same quality.

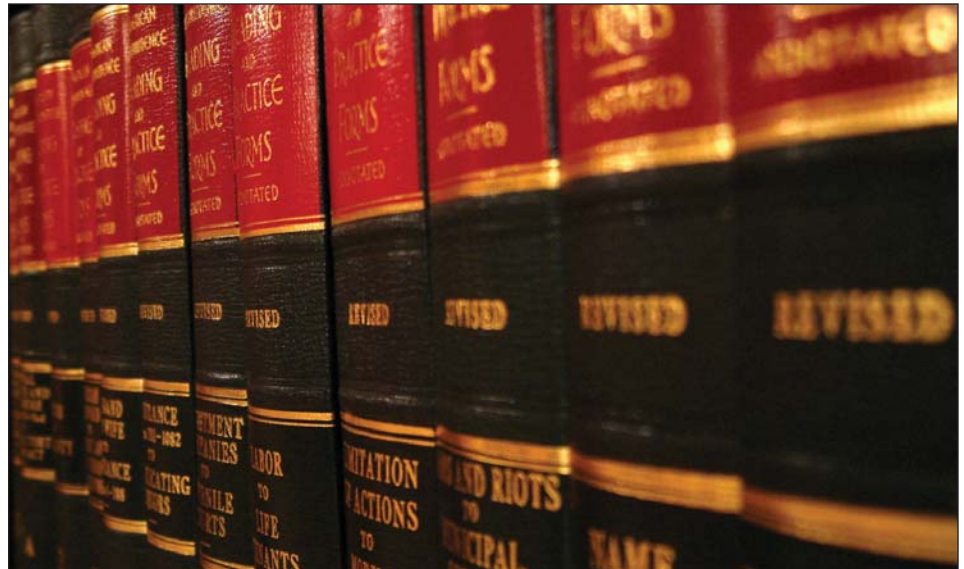
So one can see why an increase to either the corporate level tax rates or the shareholder level tax rates would affect the value of the business. In fact, when Congress limited the tax rate on dividend income to a maximum of 15%, one reason

for doing so was stated to be that it would help drive up the value of corporate America. So a change in the opposite direction should have the opposite affect on value.

Pass-through entities avoid the C corporation level of tax. This includes S corporations, limited liability companies, partnerships, and sole proprietorships. Their income is taxed to the owners and is also distributable to them. However, unlike dividends from a C corporation, pass-through entity income is subject to the owner's ordinary income tax rates rather than a maximum rate of 15%. Ordinary federal income tax rates for individuals range from 10% to 35%. Thus, entities using a pass-through structure have a value advantage over C corporations in that the overall tax burden is lower.

There are various methodologies used by business valuation professionals to quantify this value advantage. In the now-famous Delaware case, *Kessler vs Delaware Open MRI Radiology Associates, PA* (C.A. No 275-N), the value advantage of the pass-through structure was recognized and quantified by applying the above three maximum rates side by side. Subsequently, various state courts have adopted the Delaware methodology.

Given that the federal deficit has mushroomed in recent years, and additional tax revenues are necessary to pay down the consequent debt, it is now likely that federal tax rates will rise, and the special rate on dividends will change. Depending on which rates change and by how much, the current value formulas may need some modification going forward. In general, any tax rate increase will result in a diminution of business value. Stay tuned.



Family Limited Partnerships and the Courts—An Update

The use of family limited partnerships (FLPs) for business, gifting, and estate planning purposes has been widely successful. An FLP may allow an individual to retain control over family assets, protect those same assets from creditors, and provide a vehicle for transfer of ownership of those assets from one generation to another.

But the improper development or use of an FLP can result in a significant loss of those assets to taxes and penalties. From the inception of the FLP as a tax planning entity, the Internal Revenue Service (IRS) has challenged its use by various means. The IRS has made its challenges based on a number of general issues: (1) economic substance and validity of business use of the FLP; (2) valuation discounts; (3) gifts on formation of the FLP; and (4) various Internal Revenue Code (IRC) Chapter 14 considerations.

The key to anticipating where the IRS will focus its efforts regarding challenges may be found in various tax court cases. In the past couple

of years, and beginning this discussion with the *Astleford* case (*Astleford v. Commissioner*, T.C. Memo 2008-128, May 5, 2008), the IRS has challenged more FLPs on their validity as business entities or that transfers did not constitute a bona fide sale for adequate and full consideration than it has on valuation discounts. As a matter of fact, in the *Astleford* case, the Tax Court accepted both a significant combined discount for lack of marketability and control related to a 50% general partnership interest and acceptance of a significant “tiered” discount for multiple ownership levels.

In 2009, in the Estate of *Valeria M. Miller v. Commissioner* (T.C. Memo 2009-119, May 27, 2009) the IRS did not contest the 35% discount for lack of marketability on the FLPs marketable securities but challenged the transfer as not constituting a “bona fide sale” under IRC Section 2036(a). This case involved two transfers and the Tax Court split its decision, allowing the initial transfer but disallowing the second transfer as driven by the desire to reduce

the taxpayer’s taxable estate, as the elderly taxpayer’s health took a precipitous drop just prior to the transfer.

Interestingly enough, more recently, in *Estate of Shurtz v. Commissioner* (T.C. Memo 2010-21, February 3, 2010) the Tax Court decision does not even mention the word “discount.” As in the *Miller* case, the IRS challenge was based on IRC Section 2036(a), that the decedent had retained control, use, and benefit of the assets within the meaning of Section 2036 and/or 2035(a); the asset in this case being timberland in Mississippi. Here, the Tax Court sided with the taxpayer and against the IRS, citing the earlier cases of *Bongard* and *Bigelow*, and stating that the transfer of assets into the limited partnership was based on a bona fide sale for adequate and full consideration.

These recent court cases should not lull the valuation community into a false sense of security regarding discounts that are applied in FLP transfers. The IRS will continue to challenge the use and

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operation of FLPs by all available means, from business purpose to discounts. The key problem is in following form for the FLP, keeping it as an independent entity. Taxpayers lose when the FLP and personal assets become indistinguishable, personal use property is included in the FLP, there is commingling or personal use of funds, disproportionate distributions, and similar issues. It is imperative that the legal form of the FLP remain intact.



Breach of Contract

The calculation of damages from the breach of a contract involves the analysis of historical financial data, analysis of the current status of the parties involved, and projections of future economic activity. In most breach cases there is a basic formula used to calculate damages. In simple terms, the difference between what would have happened without the breach of contract and what did happen as a result of the breach of contract is the economic damage. Quantifying that difference is based on a combination of actual verifiable data, assumptions, and projections.

There are three phases of most damage calculations. First is the period from the commencement of the contract to the date of the “event” (breach). Generally, this is the period where data is most available, relevant, and reliable. The second phase is the period from the date of the breach to the date of trial. The information in this period is also reliable and relevant but, depending on the circumstances surrounding the breach, may not be readily available. The third phase is the period of time from date of trial into the future. This is the period where economic activity is projected and is, by definition, the least reliable or available. It is also the phase where assumptions play a significant role in the calculations. It must be prepared and presented in a form, though, that is relevant and persuasive.

The role of the expert in a breach of contract matter is to assist the parties in quantifying the damages. This may involve assistance in discovery, developing reasonable assumptions, reading and interpreting contracts, compiling financial data, and presenting the data. Discovery will be based on the theory of damages being pursued, and an experienced forensic accountant can drive a more efficient process of collecting and using relevant data.

Presentation of the conclusions and the basis for the conclusions is often critical to the success of the engagement. There are a lot of experts who can do an adequate or even superior job in the analysis stage but cannot present the data in a form that is understandable and reasonable for a trier of fact to adopt. Conversely, there are experts who tell a good story but do not have the analytical skills required. They either have others do the analysis and step in personally only to provide the testimony or they do scant analytical work and rely on their testifying skills to carry the day. Finding both skills in one expert brings efficiency to the damages phase of the case. Regardless of the venue (jury trial, bench trial, or arbitration) the ability to present the conclusions in an easily understood presentation that is backed up with substantial data not only can win the case, it can also assist in settling the case before incurring the expense of a trial.

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The following are some traps to avoid when retaining an expert to provide consultation and/or expert witness work in the damages phase of a breach of contract matter:

- Retaining the damages expert right before trial (at the last minute) is common but dangerous. Depending on the circumstances, clients are sensitive to litigation costs and there is a working theory that the damage phase will be addressed if/when there is a decision that the damage actually took place. By doing so, any advantage of having a financial expert assisting with discovery and development of damages theories is lost. Additionally, experienced and busy financial experts will either be unavailable or have a policy of not taking on “last minute” cases.
- Telling the expert what you want the damages to be is ultimately self-defeating. Reputable experts will not allow themselves to be used in that manner. Often, it comes out in trial either directly or by implication and has a negative impact on results.
- Retaining an expert who is weak either analytically or in presentation skills is an unnecessary compromise. The expert should be allowed to prepare the necessary analysis as well as design exhibits with the client and lawyers that are clear, expressive, and persuasive. This is often an interactive process that results in a smooth presentation.

Retaining an expert who is experienced in this type of work and has the communication skills to present the evidence and the conclusions in an understandable way is the key to success in this type of litigation. It not only provides an edge in trial, it can often facilitate the successful settlement of a case without incurring the cost of a trial.

**If you have any questions,
please contact our office . .**



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