



## Two Landmark Cases Still Offer Reasonable Compensation Guidance

Two landmark court cases still provide attorneys, CPAs, and appraisers with a robust analytical framework to assess reasonable compensation in business valuations.

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 that 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 expense 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.

## Critical Questions to Assess the Value of Patented Inventions

The value of a patented invention becomes important in current accounting practices, given the requirement for intangible assets to be recorded at their “highest and best use.” Essentially, this requires valuing the probability that the invention’s owner will obtain a licensing agreement with a company capable of delivering the patented invention to market. To assess the probability of securing a

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license, accounting executives, auditors, and their attorneys should discuss the following factors with their valuation experts:

- *Market potential.* Does demand for the patented invention already exist? Technologies that facilitate natural extensions of products into new markets offer high risk-adjusted value (e.g., placing social media applications on “smart” phones).
- *Strategic motivation.* How badly does the customer need the technology? Firms with enormous revenues at risk, high rates of obsolescence, and few remaining years of patent life (e.g., pharmaceutical companies) are usually motivated to adopt new technology. By comparison, firms that face less competition and deliver basic technology are likely to wait until the technology expires.
- *Investment costs.* What is the cost to deliver the technology to the market? How long will it take to deliver? Will market demand continue in the meantime?
- *Development risks.* Is the technology in early stages of development or is it already incorporated into a product? Does the license include all of the relevant technology? How might the license infringe on existing, lawful patents?
- *Implementation risks.* Has the technology been independently validated (e.g., by a “freedom of operation” opinion letter, business model, or customer contract)?
- *Genesis of the invention.* Who brought the invention to the licensee’s attention? Offers from licensing agents, patent brokers, or lawyers have often been vetted and are well-received by licensees. Inventions that solve “real” problems are also better received than those developed by happenstance.
- *Licensee’s commitment.* Has the licensee developed licensed technology in the targeted markets? Does the technology serve the licensee’s primary or ancillary business units? Are there sufficient research dollars, personnel, capital, and capacity to deliver the product—or do the licensee’s lawyers, R&D, or other staff oppose the initiative?
- *Inventor’s reasonableness.* Does the inventor have unrealistic expectations regarding the invention’s value? Is the inventor willing and able to participate in negotiations? Is the inventor committed to improving and/or commercializing the technology?

- *Negotiations.* Do the negotiators have appropriate decision-making authority? Is there an internal champion for the project? Are negotiations progressing smoothly? Is the licensee willing to sign off on nondisclosure agreements, term sheets, etc.?

## ***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

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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 the marketability discount violated the fair market value standard.

## **Five Keys to Protecting Your Financial Expert’s Credibility in Court**

Attorneys are becoming increasingly sophisticated about business valuation, making it easier for the best of them to pick apart an expert witness’ testimony. It’s not enough that your expert is qualified by credentials and credibility. To “bullet proof” your expert witness in court against even the most aggressive cross-examination, take note of these five quick tips:

1. *Avoid “puffery.”* One of the easiest ways to discredit financial experts is by identifying areas subject to “puffing”—i.e., where they have exaggerated or overstated their qualifications. For example, if an expert boasts he has 25 years of business valuation experience, a good lawyer will ask methodical, detailed questions about that experience. If, at the end of the questioning, it turns out that the expert has been working for 25 years but has only performed four appraisals of the type at issue in the litigation—that’s puffing, and it can damage the expert’s credibility.
2. *Avoid overconfidence.* Financial experts want a court to take their qualifications seriously, but in an effort to impress the trier of fact, they may take an overly confident or “blustery” approach. (“I’ve been doing business valuation forever and

I know everything” is an exaggerated example.) Make sure your experts aren’t caught trying to look as though they have more experience than they in fact do.

3. *Affirm the data.* There are two aspects to reliable expert evidence. First, an expert’s valuation must be based on reliable underpinnings. The witness must be able to answer the questions, “Where did you get the data?” “Do you know how the data are collected and compiled?” It is up to the expert to substantiate the source of the inputs supporting his or her opinion, and to disclose (per the Federal Rules) all the documents and data that went into that opinion. *Practice tip:* Ask your testifying experts to come up with a working list or chart of what they need to form their ultimate opinions and discuss any materials that may not be available or forthcoming. Revisit the list later in the litigation to make sure the expert received the materials *and* reviewed them.
4. *Affirm the methods.* Second, an expert’s methods must be reliable. For example, courts may be skeptical if an expert fails to perform a discounted cash flow analysis when conducting an enterprise valuation, or fails to explain why it wasn’t appropriate in the particular case. If your expert does conduct a DCF, make sure the analysis conforms to valuation authorities’ and generally accepted techniques.
5. *Reaffirm educator role.* Remember that the role of your financial expert is to assist the judge or the jury in understanding a complicated, specialized area of knowledge. The bar against unreliable, irrelevant testimony is high, so make sure your experts rely on generally accepted valuation methodologies and omit anything novel or unproven. In addition, make sure your experts can describe their credentials and experience fairly and accurately, without overstatement. Finally—help them disclose and obtain all the materials they need to support their expert opinions, or risk surprise and loss of credibility at trial.

## **Tax Court Finds ‘Good’ FLPs Come from Good Families**

***Estate of Shurtz v. Commissioner, 2010 WL 374528 (U.S. Tax Ct.)(Feb. 3, 2010)***

For nearly 30 years, Charlene Shurtz and her husband, an ordained minister, performed missionary

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work overseas. When they returned to the U.S. in 1996, they continued to do church work and donate substantial sums to charity from Mrs. Shurtz's independent wealth: She owned a 16% limited partnership interest in her family's timber company as well as 780 acres of prime Mississippi timberland.

To plan and preserve their estate, the Shurtzes formed a family limited partnership (FLP). Because she owned the timber outright, Mrs. Shurtz transferred a 6.6% interest to her husband, who exchanged this for a 1% general partnership interest in the FLP. At the same time, Mrs. Shurtz donated all the remaining timber to the FLP plus her 16% interest in the operating company, for which she also received a 1% general partnership interest and 98% limited partnership interest in the FLP. From 1996 until 2002, Mrs. Shurtz gifted numerous interests to her children and grandchildren, reducing her LP interest to 87.6%.

The partnership maintained capital accounts and issued appropriate disclosures. It did not keep formal books, although the family's CPA created schedules to track balances and prepare taxes. The FLP had a money market account, but relied on the Shurtzes to pay some disbursements from their personal accounts, ultimately reimbursing them or crediting their capital accounts. Partner distributions were not always proportionate, but the FLP made up any discrepancies over time. The FLP held regular meetings in conjunction with the family timber business; its timber holdings required active management, including annual planting, reforestation, and maintenance.

When Mrs. Shurtz died in 2002, her 87.6% LP interest was valued at just over \$6.1 million and her GP interest at \$73,500. Because her estate plan disbursed nearly its total value—over \$8.7 million—to qualified marital and other trusts, it claimed no

estate taxes were due. The IRS disagreed. Pursuant to IRC Sec. 2036(a), it taxed the full value of the FLP's underlying assets. The taxpayer claimed the Sec. 2036(a)(1) exception applied (i.e., the FLP transfers constituted a bona fide sale for adequate consideration). To resolve the issue, the Tax Court looked to the following factors in support of the FLP's bona fide, non-tax business purpose:

- The Shurtzes had a legitimate concern to protect their family's assets from creditors. Mississippi is particularly known for its "jackpot justice," the court said, and FLPs are a "customary response" to guard against potential lawsuits.
- The FLP facilitated the management of the timberland, which comprised less than 16% of the FLP's total assets, but was sufficient to support the stated business purpose. By giving away 6.6% of her acres to her husband, Mrs. Shurtz also helped establish a bona fide transfer.
- The partnership conducted regular business with respect to the timberland, including an annual amortization of expenses and a realized gain from a 1997 harvest.
- The partners received interests in the FLP proportionate to their ownership contributions, and their accounts were properly adjusted for any contributions and distributions.

In conclusion, the court found that the FLP "was carried out in the way that ordinary parties to a business transaction would do business with each other." Thus, the transfers fell within the Sec. 2036 exception, and the fair market value of Mrs. Shurtz's FLP interest, rather than the fair market value of the contributed property, was includable in her gross estate, with no additional estate taxes due.



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