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# LITIGATION SUPPORT



TAXES

*Raley v. Brinkman*

Should pass-through earnings be tax affected?

Forensic accounting investigations

Expertise is critical when conducting interviews

Tax issues to consider in divorce settlements

Court explains “built-in”  
apportionment in royalty calculation

## *Raley v. Brinkman*

# Should pass-through earnings be tax affected?

The Tennessee Court of Appeals recently weighed in on the ongoing debate over whether a pass-through entity's projected future income should be reduced for hypothetical corporate income taxes when valuing the business. In *Raley v. Brinkman*, the court found that so-called "tax affecting" was appropriate in a buyout case involving a pass-through entity.

### **Restaurateurs' relationship sours**

The plaintiff and the defendant each held 50% interests in a limited liability company (LLC) formed to own and operate a restaurant. The restaurant opened in late 2011 and, by 2016, had gross annual income of about \$3.4 million.

In March 2015, the relationship between the owners began to deteriorate. They eventually stopped communicating with each other and hired attorneys. In 2016, this lawsuit was filed, alleging breach of contract. The defendant counterclaimed, alleging breach of contract, conversion and misappropriation.

The trial court found the personal and business relationships between the parties had been destroyed by the plaintiff's wrongful conduct and terminated his interest in the LLC. Under the applicable state law, the defendant chose to buy out the plaintiff's interest, which required the court to determine its "fair value."

The court noted that the cash flows and discount rate should be treated consistently when valuing a pass-through entity.

Before the fair value evidentiary hearing, the court rejected the defense expert's application of a hypothetical 38% corporate income tax rate to the business's income stream. It found such tax affecting inappropriate as a matter of law. The defendant subsequently appealed.

### **Court orders tax affecting**

The owners elected to treat the LLC as an S corporation for income tax purposes. The defendant contended that tax affecting was appropriate because the income from an S corporation passes through to the owners' individual tax returns and is taxed at the owners' personal tax rates. He further argued that business valuation experts commonly use after-tax income values to calculate the capitalization rate under the income



## Discounts disallowed

The trial court in *Raley v. Brinkman* (see main article) specifically excluded evidence and testimony related to discounts for lack of control and marketability. On appeal, the defendant who was buying out the other owner's interest asserted that the lower court should have allowed such discounts.

However, the Court of Appeals upheld the trial court ruling. It explained that the applicable statutory appraisal process doesn't attempt "to reconstruct a pro forma sale." Rather, it assumes that the remaining owner was willing to maintain his investment position. Therefore, valuation discounts — based on a theoretical sale to a third party — are inappropriate.

In addition, the court said, a discount for lack of control was unnecessary because, under the applicable statutes, it was the *company* buying the membership interest, not a third party. Likewise, a discount based on the marketability of minority interests isn't relevant when valuing a controlling interest in the company at the entity level. As a result, it would be inequitable to apply valuation discounts when buying out the 50% interest in the restaurant.



approach. The plaintiff countered that tax affecting would be improper because the S corporation didn't pay corporate-level income tax.

The appellate court explained that the problem with using the income approach to value an S corporation is that the approach is designed to discount cash flows of C corporations, which are taxed at both the entity and the shareholder level. S corporation income is taxed only at the shareholders' personal level.

For guidance, the court turned to another case dealing with the fair value of a going-concern S corporation: In *Delaware Open MRI Radiology Associates*, one expert tax affected the earnings as if the business was a C corporation. The opposing expert didn't tax affect at all. In this bankruptcy case, the court found a middle ground between the experts' approaches. It concluded that declining to tax affect an S corporation's earnings would *overvalue* it. But charging the full corporate rate would *undervalue* the business by failing to recognize the tax advantages of S status.

The Court of Appeals found this reasoning persuasive in the current case. Because each owner pays taxes on the business's income on his individual tax return, tax affecting would help the court determine the going-concern value of the business.

The court also highlighted the defense expert's testimony that he used an income based on *after-tax* earnings because his capitalization rate was based on *after-tax* values. And the court found it significant that the defense expert's methodology mirrored that of the U.S. Tax Court. For example, in *Estate of Jones*, the Tax Court noted that the cash flows and discount rate should be treated consistently when valuing a pass-through entity.

### The takeaway

This case is unlikely to be the last on the question of tax affecting. The propriety of the practice for any given case will turn on a variety of factors, including the applicable statutes and case law, the type of case and the relevant standard of value. ■

# Forensic accounting investigations

## Expertise is critical when conducting interviews

**D**uring fraud investigations, interviews of witnesses and suspects are used to gather information to help answer “who, what, when, where, how and why” questions. Care should be taken when interviewing company personnel and gathering other evidence to protect the chain of custody and ensure that the findings can be admitted in a legal proceeding. That’s why it’s critical to hire an objective, outside professional to investigate fraud suspicions.

### What to ask

A qualified forensic accounting expert is trained to understand the difference between objectively *interviewing* witnesses to gather facts and forcefully *interrogating* them to obtain a confession. Though witnesses may occasionally confess to wrongdoing during an interview, that’s not the primary objective. Interviews should be professional, nonthreatening discussions primarily with company personnel.

When conducting interviews, experts generally mix different types of questions, including:

**Open questions.** These questions encourage an orderly and continuous narrative of an event or incident. They help elicit a quick summary of what’s known about a matter. When an interviewee is

offering a narrative, interviewers generally shouldn’t interrupt the process.

**Close-ended questions.** These solicit yes-or-no answers. Closed questions also can be used to establish dollar amounts, dates, times and locations.

**Leading questions.** Some questions contain an answer as part of the question. They can be used to confirm facts that are already known. Leading questions typically aren’t allowed in courtroom situations, but they can be an effective technique during the interview process.

Under most circumstances, experts prefer to start with questions that focus on general information, and then move to more specific questions. They also avoid confrontational and emotive words that may lead to a termination of the interview.

### Whom to interview

The interview process usually begins with neutral fact witnesses and moves to witnesses who may possess more corroborative information. Simple background questions — about the witness’s name, title, job duties and experience — are used to build rapport. Then the forensic expert can ask for the names of other potential witnesses and

documents to support responses. It also may be appropriate to gather information about suspects, such as their work habits, any unusual behaviors, lifestyles and personal activities.

In some cases, experts interview people *outside* the organization, such as former employees and people who may have inside information on a suspect, such as former spouses and friends. But these witnesses may lack objectivity, so it’s important to corroborate the findings of their interviews with additional research.



Suspects are normally interviewed toward the end of the interview process, after information and evidence have been gathered from witnesses. However, the timeline may be revised in some circumstances. For example, suspects may be questioned earlier in the investigation if a forensic expert is concerned that evidence may be destroyed, the suspect will leave the company or fact witnesses are receiving threats. Care also should be taken to mitigate financial losses in fraud cases.

### Beyond words

In addition to asking relevant questions, experienced forensic accounting experts also know how to actively *listen* to responses. This means hearing what's being said and how it's being communicated. Sometimes, what a witness isn't saying is just as important as what he or she has said.

Experts also look for red flags of lying during an interview. Examples of physical responses that may indicate deception include:

- Making hand motions,
- Blinking excessively,
- Picking lint off clothing,
- Playing with objects,

- Tapping a foot or pen,
- Holding objects or documents between themselves and the interviewers, or
- Presenting a fleeing position where the feet are pointed towards an exit while the upper body points towards the interviewers.

In addition, deceptive people might start to ask their own questions or repeat questions to buy time to formulate responses. Or they may become defensive, angry or accusatory toward the interviewer.

Background questions can help determine a baseline for an individual's responses. As the interview progresses, it's important to note any changes from the known baseline.

### Embracing a team approach

Forensic accounting investigations can lead to criminal and civil lawsuits. So, it's important for experts to work with legal counsel while conducting interviews and gathering other evidence to support fraud allegations. For this information to be admitted in court, the trier of fact must be convinced that statements were made voluntarily, that evidence was lawfully gathered and that it hasn't been altered. Each case presents a different set of circumstances and complicated legal issues. ■

## Tax issues to consider in divorce settlements

**W**hen settling a marital estate, it's important to consider tax issues — especially as federal tax laws are expected to generally become less favorable with the change of administration. According to current tax law, child support payments and alimony payments made under agreements executed *after* 2018 aren't deductible by the paying spouse (or taxable to the recipient). But what are the

tax implications of transferring marital assets between spouses when a divorce is settled and beyond?

### Most transfers are initially tax-free

Divorcing spouses can divide most assets, before a divorce or at the time it becomes final, without any federal income or gift tax consequences. Tax-free

treatment also applies to post-divorce transfers as long as they're made incident to divorce. The spouse who receives the asset takes over its existing tax basis (for tax gain or loss purposes) and its existing holding period (for short-term or long-term holding period purposes).

An exception to the tax-free transfer rule is qualified retirement plan accounts, such as 401(k), profit-sharing or pension plan accounts. The commonly preferred method to handle these assets is to set up a "qualified domestic relations order" (QDRO). Without a QDRO, transfers of account assets between spouses may, in the year received, be subject to unfavorable tax treatment.

### Post-divorce tax issues are critical

After the divorce is finalized, there may be tax implications for assets received tax-free in the divorce settlement. The person who winds up owning an appreciated asset — where the fair market value exceeds the tax basis — generally must recognize taxable gain when the asset is sold, unless an exception applies.

From a net-of-tax perspective, appreciated assets are worth less than an equal amount of cash or other assets that haven't appreciated.

Appreciated assets come with a built-in tax liability. So, from a net-of-tax perspective, appreciated assets may be worth less than an equal amount of cash or other assets that haven't appreciated.

### Different assets, different treatments

The spouses' former home is a common example of an asset that appreciates over time. Taxpayers can generally exclude from federal taxable income gains of up to \$250,000 (\$500,000 for married couples who file a joint return) on homes, as long as they've owned and used the property as their



principal residence for two of the previous five years. If a taxpayer doesn't meet the two-year ownership and use tests, any gain from the sale may qualify for a reduced exclusion due to unforeseen circumstances.

If one spouse continues to live in the home and the other moves out (but both remain owners), they may still be able to avoid gain on its future sale (up to \$250,000 each). However, special language must be included in the divorce decree or separation agreement to protect the exclusion for the spouse who moves out.

Other appreciable assets — such as vacation homes, investment properties, stocks and bonds, and private business interests — don't receive this favorable tax treatment. Instead, these appreciable assets are typically subject to capital gains tax when they're sold, assuming the assets are held for longer than a year. Beware: Capital gains tax rates are expected to increase for high-income individuals with the change of administration.

### Always factor taxes into settlements

The federal tax rules are complicated — and some are expected to change in the coming years. Achieving an equitable divorce settlement often requires the input of an experienced tax professional to determine the tax-equivalent value of marital assets. ■

# Court explains “built-in” apportionment in royalty calculation

The Federal Circuit Court of Appeals recently affirmed a massive damages award based on reasonable royalties in *Vectura Ltd. v. GlaxoSmithKline LLC*. The court dismissed the need to apportion damages among infringing and non-infringing components in the accused invention. Instead, it found that apportionment essentially was “baked in” to the prior license agreement that was the basis for the royalty calculation.

## A breathtaking award

This infringement case, filed in 2016, involved a patent for production of “composite active particles” for use in pulmonary administration, such as in dry-powder inhalers. A jury ruled in favor of the patentee and awarded a reasonable royalty of 3% of the defendant’s sales of the infringing inhalers — almost \$90 million.

The district court denied the defendant’s motion for a new trial on damages. The defendant appealed, arguing that the award was unsupported because the plaintiff’s damages theory was legally flawed.

## Apportionment unnecessary

The plaintiff’s expert presented a theory based on a 2010 license between the plaintiff and defendant. She adopted that license’s royalty rate (3%) and its royalty base (total sales of the licensed products or the entire market value). The defendant contended that the plaintiff needed to apportion her royalty base to account for the noninfringing components in the accused inhalers.

As the Federal Circuit explained, an entire market value royalty base is appropriate for damages calculations

only when the patented feature creates the basis for customer demand or substantially creates the value of the component parts. Otherwise, apportionment is necessary. But when a sufficiently comparable license is used as the basis for determining the appropriate royalty, further apportionment isn’t required if the comparable license (or comparable negotiations) has “built-in” apportionment.

Built-in apportionment effectively assumes that the negotiators of a comparable license settled on a royalty rate and royalty base combination that embodies the value of the patent. So, a party relying on a sufficiently comparable license can adopt the rate and base without further apportionment and without proving the infringing feature drove the entire market value of the accused product.

## A caveat

The Federal Circuit cautioned that district courts considering past licenses for different technologies than the patent at issue must account for differences in the technologies and the economic circumstances of the contracting parties. Here, though, the court found “roughly very similar technologies” and that the plaintiff’s expert had considered and rejected the notion that meaningful economic differences existed. ■

